The Institute of Chartered Accountants of Bangladesh (ICAB)

Corporate Reporting

Workbook
For CA Advanced Level Exams

CA BANGLADESH | THE INSTITUTE OF CHARTERED ACCOUNTANTS OF BANGLADESH

www.icab.org.bd

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Contents

Questions within the Workbook should be treated as preparation questions, providing you with a firm foundation before you attempt the exam-standard questions. The exam-standard questions are found in the Question Bank.

CA OVERVIEW

The ICAB chartered accountancy qualification, the CA, is one of the most advanced learning and professional development programmes available. Its integrated components provide an in-depth understanding across accountancy, finance and business. Combined, they help build the technical knowledge, professional skills and practical experience needed to become an ICAB Chartered Accountant.

Each component is designed to complement each other, which means that students can put theory into practice and can understand and apply what they learn to their day-to-day work. The four components are:

ICAB constantly reviews the content of the CA qualification to reflect real life business challenges. Today's most urgent business challenges range from sustainability, to rapid changes in technology and the role of ethics in the profession. We work closely with employers, tuition providers, academics and examiners to ensure that the CA equips the chartered accountants of the future with the skills and knowledge they need to meet these challenges and to be successful.

THE CA QUALIFICATION AND SUSTAINABILITY

Finance and accounting professionals need to move beyond simply measuring and reporting the impact of climate change, environmental regulation, supply chain pressure and rising energy costs. They must focus on understanding those implications and integrating them into financial management and business planning. ICAB has been at the forefront of this movement over the past decade and has adapted the CA qualification to reflect that. We see its role as not simply integrating knowledge and understanding the broader implications of environmental, social and governance issues into organisations, but also seeding this thinking into the mindset of our members.

Our syllabus and ethical and professional development framework contribute towards creating ICAB Chartered Accountants who recognise that sustainability is at the core of what they do and are capable of actively using their business skills to analyse how to make the new sustainable economy work for their business.

THE CA QUALIFICATION AND TECHNOLOGY

Rapid growth in technology has automated many compliance elements of accountancy. But, with technology also comes complexity and risk. Accountants need to adapt and develop new skills to manage these technological changes such as data analytics, automation and cyber security.

While there are many new technology capabilities that have broad application across the business and consumer environment, four trends have the greatest potential to transform the accountancy profession: **A**rtificial intelligence, **B**lockchain, **C**yber security and **D**ata (ABCD of technology).

These and other innovations are likely to have a significant impact on the way that accountants access, move and manage business finances.

Technology can provide information more quickly and often more accurately than humans, but it cannot replicate human intelligence and quality decision making. Therefore, chartered accountants hold a key role in data analytics, in validating the source of the data, interpreting and analysing the outputs. Technology provides opportunities for chartered accountants to use their professional skills to add value to their clients and/or the businesses in which they work.

As routine and compliance work reduces, there is greater focus on the development of skills which equip professionals to work with the outputs of automated processes, with other specialists, and in a changing world.

We believe that skills such as analysis, interpretation, professional scepticism, communication, collaboration, adaptability, resilience, and commerciality are essential for tomorrow's business leaders; these are imbedded throughout the CA exams and professional development framework.

THE CA QUALIFICATION AND ETHICS

Culture and values are central to long-term success. How a business adopts an ethical approach towards its staff, shareholders, customers and regulators, as well as within its own operations, has a bigger impact than any performance measure or operational improvement.

Demonstrating a clear commitment to ethical behaviour is one of the main drivers of better performance; it delivers an advantage when recruiting, it adds value to a brand, and it instils trust and confidence in partners, suppliers and others that the organisation is well run and resilient.

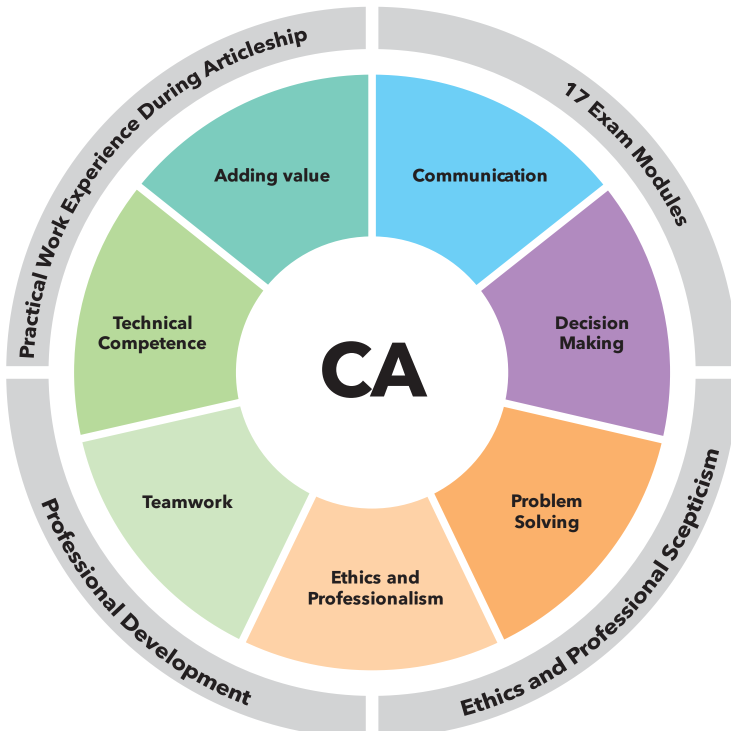
Achieving that is not a matter of simple knowledge. Few ethical challenges will have simple right and wrong responses. They require technical understanding, rigorous appraisal and skillful handling. Accountants must have the necessary skills to apply professional judgement in a given situation, taking into account what has been learned as a CA student about their ethical responsibilities as a Chartered Accountant.

There will be unique ethical challenges throughout any Chartered Accountant's process of learning and career. They serve a variety of masters: senior management, external stakeholders, regulators; and above all the public interest responsibility of their profession. Because of the rigorous and effective training (and continued professional development) chartered accountants can speak up and take a lead.

None of this can happen without one critical element: professionalism. That goes beyond merely knowing the Code of Ethics: it means embodying the right behaviours and having the ability and willingness to push back against those who might compromise the integrity of the business.

That confidence comes from a qualification that prioritises not only technical knowledge of the ethical framework but also challenges accountants with scenarios that accurately reflect the ethical dilemmas a Chartered Accountant may face in business.

PROFESSIONAL DEVELOPMENT



ICAB Chartered Accountants are known for their professionalism and expertise. Professional development prepares students to successfully handle a variety of different situations that they encounter throughout their career. The CA qualification improves students' ability and performance in seven key areas:

- Adding value – add value to the organisation, team or role in order to achieve objectives
- Communication – communicate effectively at all levels, using oral, written and presentational skills to achieve positive outcomes
- Decision making – gather, interpret and evaluate data to make effective decisions
- Ethics and professionalism – behave ethically and sustainably while respecting others to uphold the values of the organisation and the accountancy profession
- Problem solving – analyse a problem, generate options and make recommendations to arrive at appropriate solutions
- Teamwork – work collaboratively as a member or leader of a team to achieve shared goals
- Technical competence – seek, learn and use technology and technical information to support the achievement of organisation or team goals
- There are 17 exams over three levels – Certificate, Professional and Advanced.

CERTIFICATE LEVEL

There are seven exams at this level that introduce the fundamentals of accountancy, finance and business. Students may be eligible for credit for some exams if they have studied a qualification we recognise.

The Certificate Level exams are each 1.5 hours long except Business Laws and Information Technology which are 1 hour long and can be sat four times in the year.

PROFESSIONAL LEVEL

The next seven exams build on the fundamentals and test students' understanding and ability to use technical knowledge in real-life scenarios. The exams are taken in three times in the year.

The Professional Level exams are 3.5 hours long.

The Professional Level exams are flexible and can be taken in any order to fit with a student's day-to-day work. The Business Planning: Taxation & Compliance and Business Strategy and Technology exams in particular help students to progress to the Advanced Level.

The suite of Business Planning: Taxation & Compliance and Business exams is based on the same syllabus structure and skills frameworks, and will give students the opportunity to demonstrate their learning and use this in the context of taxation.

Financial Accounting and Reporting is in the contexts of IFRS Standards.

ADVANCED LEVEL

The Corporate Reporting and Strategic Business Management & Leadership exams test students' understanding and strategic decision-making at a senior level. They present real-life scenarios, with increased complexity and implications from the Professional Level exams.

The Case Study tests all the knowledge, skills and experience gained so far. It presents a complex business issue which challenges students' ability to problem solve, identify the ethical implications and provide an effective solution.

The Advanced Level exams are taken three times in the year.

The Corporate Reporting and Strategic Business Management & Leadership exams are 3.5 hours long. The Case Study exam is 4.5 hours long.

If a student is studying the CA independently, they should consider their future ambitions while selecting which exams to sit.

FLEXIBILITY

There are no regulations stipulating the order in which students must attempt the exams, allowing CA Firms to design Articleship programmes according to business needs. The exception to this rule is the Case Study. For attempting Case Study, students must be attempted the other subjects of Advanced Level.
Students have the unlimited attempts at all levels of exams.

CREDIT FOR PRIOR LEARNING (CPL)

Students with previous qualifications may be eligible to apply for CPL for modules which have been allowed by ICAB. For more information, visit **https://www.icab.org.bd/page/credit-for-prior-learning-cpl-exemption**.

DATA ANALYTICS

Chartered Accountants are increasingly using more advanced approaches to interrogate client data. To respond to this, ICAB has incorporated data analytics software within the Audit and Assurance and Corporate Reporting modules.

Embedding data analytic techniques within our exams ensures that we continue to reflect the current and future workplace and will also help to develop students' judgement, professional scepticism and critical thinking skills.

Corporate Reporting

If you are studying this exam as part of the CA qualification go to icab.org.bd website.

Module aim

To enable you to apply technical knowledge, analytical techniques and professional skills to resolve compliance and business issues that arise in the context of the preparation and evaluation of corporate reports and from providing audit services.

You will be required to use technical knowledge and professional judgement to identify, explain and evaluate alternatives and to determine the appropriate solutions to compliance issues, giving due consideration to the needs of clients and other stakeholders. The commercial context and impact of recommendations and ethical issues will also need to be considered in making such judgements.

On completion of this module, you will be able to:

- formulate, implement and evaluate corporate reporting policies for single entities and groups of varying sizes and in a variety of industries. You will be able to discern and formulate the appropriate financial reporting treatment for complex transactions and complex scenarios. You will be able to evaluate and apply technical knowledge from individual accounting standards and apply professional skills to integrate knowledge where several accounting standards are simultaneously applicable and interact.
- analyse, interpret, evaluate and compare financial statements of entities both over time and across a range of industries.
- explain the processes involved in planning an audit, evaluate internal controls, appraise risk including analysing quantitative and qualitative data, gather evidence including using data analytics software to draw conclusions in accordance with the terms of the engagement. In addition, you will be able to perform a range of assurance engagements and related tasks.
- evaluate corporate reporting policies, estimates and disclosures in a scenario in order to be able to assess whether they are in compliance with accounting standards and are appropriate in the context of audit objectives.
- identify and explain ethical issues. Where ethical dilemmas arise, you will be able to recommend and justify and determine appropriate actions and ethical safeguards to mitigate threats.

Method of assessment

The Corporate Reporting exam is 3.5 hours long. Each exam will contain questions requiring integration of knowledge and skills, including ethics. The exam will consist of three or four questions. Ethical issues and problems could appear in any of the three questions.

Specification grid

This grid shows the relative weightings of subjects within this module and should guide the relative study time spent on each. Over time the marks available in the assessment will be within the ranges of weightings below, but some variations may occur in individual examinations to enable suitably rigorous questions to be set.

	Weighting (%)
1 Corporate Reporting – Compliance	45 - 55
2 Corporate Reporting – Financial statement analysis	10 - 15
3 Audit and assurance	30 - 40
4 Ethics	5 - 10

Key Resources

Whether you're studying the CA qualification with an employer, at university, independently, or as part of an apprenticeship, we provide a wide range of resources and services to help you in your studies. Take a look at the ICAB website (icab.org.bd) for exam resources.

Skills within the CA

Professional skills are essential to accountancy and your development of them is embedded throughout the CA qualification. The level of competency required in each of the professional skills areas to pass each module exam increases as CA trainees progress upwards through each Level of the CA qualification. The skills progression embedded throughout the CA qualification ensures CA trainees develop the knowledge and professional skills necessary to successfully operate in the modern workplace and which are expected by today's forward-thinking employers.

The following professional skills areas are present throughout the CA qualification.

Skill area	Overall objective
Assimilating and using information	Understand a business or accounting situation, prioritise by determining key drivers, issues and requirements and identify any relevant information.
Structuring problems and solutions	Structure information from various sources into suitable formats for analysis and provide creative and pragmatic solutions in a business environment.
Applying judgement	Apply professional scepticism and critical thinking to identify faults, gaps, inconsistencies and interactions from a range of relevant information sources and relate issues to a business environment.
Concluding, recommending and communicating	Apply technical knowledge, skills and experience to support reasoning and conclusion and formulate opinions, advice, plans, solutions, options and reservations based on valid evidence and communicate clearly in a manner suitable for the recipient.

The following provides further detail on the professional skills that you will develop in this particular module. To see the full skills development grids, please go to icab.org.bd.

Assimilating and using information

Understand the situation and the requirements

- Demonstrate understanding of the business context
- Identify and understand the requirements
- Recognise new and complex ideas within a scenario
- Identify the needs of customers and clients
- Explain different stakeholder perspectives and interests
- Identify and explain risks within a scenario
- Identify elements of uncertainty within a scenario
- Identify ethical issues including public interest and sustainability issues within a scenario

Identify and use relevant information

- Interpret information provided in various formats
- Evaluate the relevance of information provided
- Use multiple information sources
- Filter information provided to identify critical facts

Identify and prioritise key issues and stay on task

- Identify business and financial issues from a scenario
- Prioritise key issues
- Work effectively within time constraints
- Operate to a brief in a given scenario

How skills are assessed: you may be required to:

- have a detailed knowledge and understanding of relevant regulations in financial reporting, auditing and ethics, which will need to be related to practical business scenarios and applied to any data provided. The data provided will focus on technical compliance and understanding;
- respond to instructions from a line manager, a client request or from other senior personnel. The requests may be specific, or they may be more general requiring interpretation and judgement to be applied by the student;
- evaluate the quality and relevance of information provided in the context of a particular assignment;
- evaluate inconsistencies in information provided from multiple sources;
- use different sources and types of evidence, including data analytics software and statistical tools including spreadsheets, to confirm, or question, financial statement assertions applying professional scepticism; and
- evaluate the ethical implications of making information available including confidentiality and transparency.

Structuring problems and solutions Structure data

- Structure information from various sources into suitable formats for analysis
- Identify any information gaps
- Frame questions to clarify information
- Use a range of data types and sources to inform analysis and decision making
- Structure and analyse financial and non-financial data to enhance understanding of business issues and their underlying causes
- Present analysis in accordance with instructions and criteria

Develop solutions

- Identify and apply relevant technical knowledge and skills to analyse a specific problem
- Use structured information to identify evidence-based solutions
- Identify creative and pragmatic solutions in a business environment
- Identify opportunities to add value
- Identify and anticipate problems that may result from a decision
- Identify a range of possible solutions based on analysis
- Identify ethical dimensions of possible solutions
- Select appropriate courses of action using an ethical framework
- Identify the solution which is the best fit with acceptance criteria and objectives
- Define objectives and acceptance criteria for solutions

How skills are assessed: you may be required to:

- apply technical knowledge, analytical techniques and professional skills to resolve compliance and business issues that arise in the context of the preparation and evaluation of corporate reports and from providing audit services;

- structure problems and solutions in scenario based questions which may be presented in the following forms:
  - Mini case – using data analytics software in the context of auditing but with significant corporate reporting emphasis. This may be technical, compliance or interpretive (for example including analytical procedures)
  - Financial statement analysis – including technical aspects of corporate reporting
  - Technical question on aspects of audit and corporate reporting (which may include assurance, internal audit);
- evaluate ethical problems in reporting, assurance and business scenarios;
- formulate, evaluate and implement accounting and reporting policies;
- measure and recognise assets and obligations on reported financial performance;
- assess the impact and interaction of applicable accounting principles, bases and standards;
- evaluate the impact of remuneration policies on reported performance; and
- evaluate reporting issues in relation to group scenarios and overseas activities.

Applying judgement

Apply professional scepticism and critical thinking

- Recognise bias and varying quality in data and evidence
- Identify assumptions or faults in arguments
- Identify gaps in evidence
- Identify inconsistencies and contradictory information
- Assess interaction of information from different sources
- Exercise ethical judgement

Relate issues to the environment

- Appreciate when more expert help is required
- Identify related issues in scenarios
- Assess different stakeholder perspectives when evaluating options
- Retain an overview of the business issue or scenario
- Appraise corporate responsibility and sustainability issues
- Appraise the effects of alternative future scenarios
- Appraise ethical, public interest and regulatory issues

How skills are assessed: you may be required to:

- use technical knowledge and professional judgement to identify, explain and evaluate alternatives and to determine the appropriate solutions to compliance issues, giving due consideration to the needs of clients and other stakeholders. The commercial context and impact of recommendations and ethical issues will also need to be considered in making such judgements.
- Demonstrate judgement in the following ways:
  - selecting between technical choices;
  - filtering data to identify critical elements;
  - prioritising information, issues or tasks;
  - identifying omissions in the information;
  - evaluating inconsistencies in information;

- distinguishing between the various qualities of the data provided;
- evaluating the impact of economic and political factors;
- evaluating the effects of known events;
- evaluating the appropriateness of accounting policy choice and estimation selection;
- evaluating options;
- comparing the effects of a range of estimates, outcomes or financial treatments;
- assessing the materiality of errors;
- exercising ethical judgement;
- identifying key linkages; and
- drawing appropriate conclusions from data provided to satisfy specified objectives and assessing the materiality of errors and omissions.

Concluding, recommending and communicating Conclusions

- Apply technical knowledge to support reasoning and conclusions
- Apply professional experience and evidence to support reasoning
- Use valid and different technical skills to formulate opinions, advice, plans, solutions, options and reservations

Recommendations

- Present recommendations in accordance with instructions and defined criteria
- Make recommendations in situations where risks and uncertainty exist
- Formulate opinions, advice, recommendations, plans, solutions, options and reservations based on valid evidence
- Make evidence-based recommendations which can be justified by reference to supporting data and other information
- Develop recommendations which combine different technical skills in a practical situation

Communication

- Present a basic or routine memorandum or briefing note in writing in a clear and concise style
- Present analysis and recommendations in accordance with instructions
- Communicate clearly to a specialist or non-specialist audience in a manner suitable for the recipient
- Prepare the advice, report, or notes required in a clear and concise style

How skills are assessed: you may be required to:

- draw conclusions from data, facts, calculations, judgments and own analysis;
- draw conclusions from complex assurance engagements;
- identify weaknesses in financial information systems and their potential consequences;
- distinguish between the qualities of data provided or other evidence generated;
- develop risk management solutions in an audit and corporate reporting environment;
- create report/memorandum in response to a specific technical issue and in accordance with client requirements;
- draft reasoned, practicable advice that is clear and concise, supported by calculations or analysis of technical/business issues identified;
- use judgement to select the most appropriate audit procedures in the context of risks identified;

- justify a specific recommended action when a variety of options are available; and
- explain the limitations of their conclusions or recommendations.

To help you develop your ability to demonstrate competency in each professional skills area, each chapter of this Workbook includes up to four Professional Skills Guidance points.

Each Professional Skills Guidance point focuses on one of the four CA Professional Skills areas and explains how to demonstrate a particular aspect of that professional skill relevant to the topic being studied. You are advised to refer back to the Professional Skills Guidance points while revisiting specific topics and during question practice.

Chapter 1

Introduction

Introduction

Learning outcomes

- Comment on and critically appraise the nature and validity of financial and non-financial information included in published financial statements including how these correlate with an understanding of the entity
- Appraise and explain the role and context of auditing
- Produce appropriate audit documentation
- Explain the nature and purpose of quality assurance (both at the level of the firm and the individual audit) and assess how it can contribute to risk management

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	**Using this Workbook** So far you will have studied corporate reporting and audit as separate (single silo) subjects. However, in real life, audit and corporate reporting are closely linked. Your Corporate Reporting exam is an integrated exam. As you learn the financial reporting topics, you will also learn how to audit that particular area.	**Approach** The key point to take in is that many of the financial reporting chapters have a separate 'audit focus' section, which deals with the auditing aspects of the financial reporting area you have just studied. **Stop and think** Remember that this is an integrated subject so you should always consider corporate reporting and auditing aspects together.	While the majority of the marks will always be awarded for demonstrating your corporate reporting knowledge, you will still need to explain how the audit is conducted if required. This gives guidance on how to approach the integrated material. This is the first time you have tackled an integrated exam. Two out of the three questions in the exam combine audit and financial reporting.	N/A
2	**The importance of corporate reporting** There has never been a better time to focus on the bigger picture of reporting and this section reminds you why corporate reporting matters. This section explains	**Approach** This will be mainly revision so only focus on the areas you are unfamiliar with. **Stop and think** Corporate reporting is not just a more advanced form of	This is unlikely to be examined in its entirety but the conceptual framework could always be tested.	**IQ1: Management decisions** A quick, straight forward question to get you thinking about the interaction of management accounting and external reporting.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	what corporate reporting is and how it differs from financial reporting and management accounting.	financial reporting. It is broader, going beyond the financial statements and covering auditors' reports and environmental reports.		This ties in with the importance of reporting when making decisions.
3	**The role and context of modern auditing** Clarification of what an audit is and why it is important.	**Approach** Check off in your head where you have met these points before. **Stop and think** Has anything changed since you last studied auditing?	There may be a need to explain why audit is necessary and how it works in broad terms so make sure you fully understand these points.	N/A
4	**Legal responsibilities of directors and auditors** There are some areas of legislation that you just need to know!	**Approach** Commit these to memory. **Stop and think** Can you differentiate between the various responsibilities of directors and auditors?	Be prepared to apply this knowledge if you are required to communicate any shortcomings in the auditor's report.	N/A
5	**International standards on auditing** Standards are there to guide the auditor and ensure best practice is maintained. This section also describes how the business world is currently in a state of considerable flux, with changes to the regulatory regime and the audit itself (also unchanged for now) mirrored by the generally volatile nature of the current global outlook.	**Approach** Make sure you have a good working knowledge of the regulations behind the audit. **Stop and think** Do you know what's currently happening to the regulation of the auditing profession?	Due to the significant amount of change in the profession (ironically, change is the only constant) you could definitely get a question on the current developments in the profession, so make sure you understand the various reports and their implications. Keep up to speed via ongoing research.	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive questions
6	**Audit quality management** Auditing is always facing a dilemma of commercial versus ethical aspects and quality is usually the victim when corners are cut to keep hold of clients. You need to know what sound quality is and what a firm needs to do to maintain it.	**Approach** There is a lot of content to remember – where will you be able to find this content in the exam if you need to know it? **Stop and think** Make sure you are familiar with the standards on audit quality. Note that these standards have been updated.	Exam questions could get you to either appraise the quality displayed by the auditor in a given scenario or recommend suitable policies and procedures. Quality management issues have generally been tested in Question 3 but may also arise in Question 1.	**IQ2: Addystone Fish** What are the issues here and how do they relate to the standards? **IQ3: Documentation (Revision)** As the title suggests, this should be revision from your earlier studies so use it as a good brainstorming activity. **IQ4: TrucksToGo Ltd** Spotting the issues here will not be a problem – you need to explain WHY and this may cause more of an issue.
7	**Laws and regulations** Although not required to be a legal expert, the auditor does need to understand enough to know when any kind of non-compliance could have an effect on the financial statements being audited.	**Approach** Review the content with the auditing standards. **Stop and think** Can you distinguish between the responsibilities of the directors and the auditor here?	Exam questions might ask you to consider the impact of non-compliance on the audit but you also need to be able to explain when (and how) you can disclose any non-compliance without the permission of the client (compare and contrast this with the responsibilities that are discussed in the various ethical standards in place).	N/A

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

Learning Topics

1 Using this Workbook

Section overview

- This section gives a brief outline of how this Workbook is structured and why.
- The key point is that the Corporate Reporting exam is integrated, so financial reporting and auditing must be studied together.

1.1 The importance of integration

The aim of the Corporate Reporting module is as follows:

"To enable students to apply technical knowledge, analytical techniques and professional skills to resolve compliance and business issues that arise in the context of the preparation and evaluation of corporate reports and from providing audit services.

Students will be required to use technical knowledge and professional judgement to identify, explain and evaluate alternatives and to determine the appropriate solutions to compliance issues, giving due consideration to the needs of clients and other stakeholders. The commercial context and impact of recommendations and ethical issues will also need to be considered in making such judgements."

It is clear from this that the **application** of technical knowledge (financial reporting, audit, assurance and ethics) is **integrated**, so it is appropriate that these areas are **studied together** where possible.

At earlier levels you will have tended to study subjects in isolation, but this is no longer appropriate at Advanced Level, and indeed in the real world.

Professional skills focus: Structuring problems and solutions

Although there will be a reasonably consistent structure to your exam, it is still important that you can identify the parts that relate to auditing and those that relate to corporate reporting. Start considering how you will address these two disciplines in the same question.

1.2 How this Workbook is structured

1.3.1 Principles and regulations in financial reporting and auditing

This chapter and Chapter 2 cover the role and context of auditing and general principles of corporate reporting. This will largely be revision, but some of the regulations and standards will have changed since your earlier studies. The aim is to set the more specialised topics, and the integrated areas, in context.

1.3.2 Ethics and governance

Chapters 3 and 4 look at ethics and corporate governance. These topics underpin corporate reporting and auditing, and ethical matters come up in all kinds of contexts, both in the exam and in your working life as a professional. It is necessary to cover all relevant audit principles first because, in the later chapters on reporting performance and position, the principles are applied in audit focus sections.

1.3.3 The modern audit process

In Chapters 5 to 8 we revise and build on the auditing material covered at the Professional Level. This will put you in the position where you can consider the audit and assurance issues in relation to specific financial reporting topics, the aim being to study financial reporting and auditing together.

1.3.4 Financial reporting chapters

Chapters 9 to 22 deal with the financial reporting and auditing of specific areas:

- Reporting performance
- Assets and liabilities
- Financing
- Remuneration
- Business combinations
- Reporting foreign activities
- Taxation

The financial reporting aspects are covered first, followed by an 'audit focus' section for each topic, looking at the specific audit issues arising from the financial reporting of that area, generally with examples and/or questions. For example, the chapter on share-based payment has at the end a section on auditing share-based payment.

Audit focus sections may in turn be split into general and specific sections. For example, Chapter 9 Reporting Financial Performance covers general issues, including creative accounting, for which auditors need to be alert. However, a more specific section will refer back to standards and the auditing of, for example, related party disclosures, which has its own designated ISA and particular risks. These sections allow scope for integrated examples or questions covering both corporate reporting and auditing elements.

Finally the Self-test questions for each chapter will contain integrated questions where relevant.

1.3.5 Financial analysis chapters

Once you have a thorough understanding of the financial reporting and related auditing issues, including analytical procedures, you will be in a position to analyse and interpret the financial statements. You will not have studied financial analysis before, so Chapter 23 provides an introduction, and Chapter 24 deals with more advanced topics.

1.3.6 Assurance and other related services

The Workbook concludes with coverage of assurance and related services, which can more easily be understood in the context of the knowledge you have gained in the earlier chapters.

2 The importance of corporate reporting

Section overview

- Corporate reporting embraces financial reporting, and both are different from management accounting.
- Financial statements are used to make economic decisions by a wide range of users.
- All users require information regarding:
  - financial position

- financial performance
- changes in financial position

2.1 What is corporate reporting?

2.1.1 Financial reporting

Financial reporting is the process of identifying, measuring and communicating economic information to others so that they may make decisions on the basis of that information and assess the stewardship of the entity's management.

Financial reporting involves:

- recording transactions undertaken by a business entity;
- grouping similar transactions together which are appropriate to the business; and
- presenting periodic results.

Financial reporting focuses on the preparation of published financial information. Typically, this information is made available annually or half-yearly (sometimes quarterly) and is presented in formats laid down or approved by governments in each national jurisdiction.

2.1.2 Corporate reporting

Corporate reporting is a broader term than financial reporting, although the two are often used interchangeably. As will be evident from this Workbook and the exam it prepares you for, **corporate reporting covers reports other than financial statements,** in particular auditors' reports, but also assurance, internal audit and environmental reports. The definition of corporate reporting varies and could include integrated reporting, corporate governance, corporate social responsibility and other narrative reporting such as the Management Commentary.

In the context of professional accountancy examinations, a corporate reporting exam is generally higher level than a financial reporting exam. In the context of your examination, Corporate Reporting is a more appropriate title because the exam is not just on financial reporting.

General principles relating to corporate reporting are set out in the IASB *Conceptual Framework for Financial Reporting* (Conceptual Framework), which is covered in Chapter 2, together with regulatory matters and selected IFRS® Standards that set out principles and frameworks.

2.1.3 Management accounting

By contrast, **management accounting** or reporting is **internal reporting** for the use of the management of a business itself. Internal management information can be tailored to management's own needs and provided in whatever detail and at whatever frequency (eg, continuous real-time information) management decides is best suited to the needs of their business.

The distinction is not so clear-cut, in that management decisions may be affected by external reporting issues, for example, if a director's bonus depends on profit. These matters are covered in Chapter 24 on the more advanced aspects of financial analysis.

Interactive question 1: Management decisions

Can you think of another example of a way in which management decisions may be influenced by external reporting requirements?

See **Answer** at the end of this chapter.

2.2 Entity

Most accounting requirements are written with a view to use by any type of accounting entity, including companies and other forms of organisation, such as a partnership. In this Workbook, the term 'company' is often used, because the main focus of the syllabus is on the accounts of companies and groups of companies, but IFRS generally refer to entities.

2.3 Financial statements

The principal means of providing financial information to external users is the annual financial statements. Financial statements provide a summary of the performance of an entity over a particular period and of its position at the end of that period.

A complete set of financial statements prepared under IFRS comprises the following:

- The statement of financial position
- The statement of profit or loss and other comprehensive income or two separate statements being the statement of profit or loss and the statement that presents the other comprehensive income (statements of financial performance)
- The statement of changes in equity (another statement of financial performance)
- The statement of cash flows
- Notes to the financial statements

The notes to the financial statements include the following:

- Accounting policies ie, the specific principles, conventions, rules and practices applied in order to reflect the effects of transactions and other events in the financial statements
- Detailed financial and narrative information supporting the information in the primary financial statements
- Other information not reflected in the financial statements, but which is important to users in making their assessments (an example of this would be the disclosures relating to contingent assets or liabilities)

  The individual elements that are included in the financial statements are covered in detail later in this chapter.

2.4 Requirement to produce financial statements

Limited liability companies are **required by law** to prepare and publish financial statements annually. The form and content may be regulated primarily by national legislation, and in most cases must also comply with Financial Reporting Standards.

In Bangladesh, **all companies** must comply with the provisions of the **Companies Act 1994 (Amended) (CA1994).** The key impact of this is as follows:

- Every registered company is required to prepare **financial statements** for each financial year which give a **true and fair view in accordance with the International Financial Reporting Standards (IFRSs).**

2.5 Financial reporting standards

Company financial statements must also comply with relevant reporting standards. In Bangladesh these are as follows.

- **IFRS**
- The Financial Reporting Act, 2015 requires Public Interest Entities (PIE) to prepare financial statements in accordance with the IFRSs.

Important note

These learning materials assume the preparation of financial statements in accordance with IFRS.

2.6 Fair presentation

IAS 1, *Presentation of Financial Statements* requires financial statements to 'present fairly' the financial position and performance of an entity.

'Present fairly' is explained as representing faithfully the effects of transactions. In general terms this will be the case if IFRS are adhered to.

IAS 1 states that **departures** from international standards are only allowed:

- in extremely rare cases; and
- where compliance with IFRS would be so misleading as to conflict with the objectives of financial statements as set out in the *Conceptual Framework*, that is to provide information about financial position, performance and changes in financial position that is useful to a wide range of users.

2.7 Judgements and financial statements

Although IFRS narrow down the range of acceptable alternative accounting treatments, there are still many areas which are left to the discretion of the directors of the company. On the whole, the concept of faithful representation should result in transactions being 'presented fairly'. However, commercial and financial considerations may result in pressure being brought to bear to account for and report transactions in accordance with their strict legal form rather than their true substance. This can raise ethical questions for a professional accountant.

Professional skills focus: Applying judgement

In the exam, as in real life, you will come across a situation where the directors have applied their own judgement about a financial reporting treatment in a way that may be influenced by self-interest, for example showing a higher profit in order to receive a higher bonus. You will need to challenge this judgement by applying your own judgement and knowledge. Questions may not always have one definitive answer. Make sure you are able to consider the best outcome for the situation as it is presented.

2.8 Users of financial statements

The form and content of financial statements must be influenced by the use to which they are put. Financial statements are used to make economic decisions, such as:

- to decide when to **buy, hold or sell an equity investment**
- to assess the **stewardship or accountability of management**
- to assess an entity's ability to pay and **provide other benefits to employees**
- to assess **security** for amounts lent to the entity
- to determine **taxation policies**
- to determine **distributable profits and dividends**
- to prepare and use **national income statistics**
- to **regulate** the activities of entities

Much of the information needed for these different decisions is in fact common to them all. Financial statements aimed at meeting these common needs of a wide range of users are known as '**general purpose**' financial statements.

We can identify the following **users** of financial statements:

- Present and potential investors
- Employees
- Lenders
- Suppliers and other trade payables
- Customers
- Governments and their agencies
- The public

Their specific information needs and how these needs may be addressed are covered in Chapter 23, the first of two chapters on financial analysis. In most cases the users will need to analyse the financial statements in order to obtain the information they need. This might include the calculation of accounting ratios.

2.9 Objective of financial statements

The objective of financial statements is to provide information about the reporting entity's **financial position and financial performance that is useful to a wide range of users in making economic decisions**.

This objective can usually be met by focusing exclusively on the information needs of present and potential investors. This is because much of the financial information that is relevant to investors will also be relevant to other users.

2.10 Accountability of management

Management also has a **stewardship role**, in that it is accountable for the safekeeping of the entity's resources and for their proper, efficient and profitable use. Providers of risk capital are interested in information that helps them to assess how effectively management has fulfilled this role, but again this assessment is made only as the basis for economic decisions, such as those about investments and the reappointment/replacement of management.

It is also the case that in a smaller entity the owner and manager can be the same individual.

Financial reporting helps management to meet its need to be accountable to shareholders, and also to other stakeholders (eg, employees or lenders), by providing information that is useful to the users in making **economic decisions**.

However, financial statements cannot provide the complete set of information required for assessing the stewardship of management.

2.11 Financial position, performance and changes in financial position

All economic decisions are based on an evaluation of an entity's ability to generate cash and of the timing and certainty of its generation. Information about the entity's financial position, performance and changes in financial position provides the foundation on which to base such decisions.

2.11.1 Financial position

An entity's financial position covers:

- the **economic resources** it controls;
- its **financial structure** (ie, debt and share finance);
- its **liquidity and solvency**; and
- its **capacity to adapt to changes** in the environment in which it operates.

Investors require information on financial position because it helps in assessing:

- the entity's ability to **generate cash in the future**;
- how **future cash flows will be distributed** among those with an interest in, or claims on, the entity;
- requirements for **future finance** and ability to raise that finance; and
- the ability to meet **financial commitments** as they fall due.

  Information about financial position is primarily provided in a **statement of financial position**.

2.11.2 Financial performance

The profit and the comprehensive income earned in a period are used as the key measures of an entity's financial performance. Information about performance and variability of performance is useful in:

- assessing **potential changes in the entity's economic resources** in the future;
- **predicting the entity's capacity to generate cash** from its existing resource base; and
- **forming judgements** about the effectiveness with which additional resources might be employed.

Information on financial performance is provided by:

- the **statement of profit or loss and other comprehensive income**
- the **statement of changes in equity**

2.11.3 Changes in financial position

Changes in financial position can be analysed under the headings of **investing, financing** and **operating activities** and are presented in a **statement of cash flows**.

Cash flow information is largely free from the more **judgemental allocation and measurement issues** (ie, in which period to include things and at what amount) that arise when items are included in the statement of financial position or performance statements. For example, depreciation of non-current assets involves judgement and estimation as to the period over which to charge depreciation. Cash flow information excludes non-cash items, such as depreciation.

Cash flow information is therefore seen as being **factual in nature**, and hence more reliable than other sources of information.

Information on the generation and use of cash is useful in evaluating the entity's ability to generate cash and its need to use what is generated.

These issues are treated more formally in the *Conceptual Framework,* discussed in Chapter 2.

3 The role and context of modern auditing

Section overview

- The audit provides assurance to shareholders.
- The audit enables the auditor to form an opinion as to whether the financial statements give a true and fair view.
- An expectation gap may exist between what stakeholders expect the audit to achieve and what it is actually designed to achieve. Despite recent efforts to narrow this gap, it remains wider than it should be due to a number of factors.

- You should be familiar with the audit process from your earlier studies.
- All companies, except those meeting exemption criteria, must have an annual external audit.
- The Companies Act sets down the responsibilities of the directors and auditors.

3.1 Purpose of the audit

The audit provides a mechanism for shareholders to help ensure that directors are acting in the company's best interests and therefore plays a fundamental **stewardship role**.

ISA 200 *Overall Objectives of The Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing* sets out the purpose of an audit as follows:

"The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. (ISA 200: para.3)"

3.2 Part of the economic infrastructure

The audit is also a vital function of economic activity. For that economic activity to continue to flourish there has to be trust.

While the audit has a crucial role to play in providing assurance to shareholders, it cannot be seen in isolation. For example, the directors of the company have a role to play in the preparation of financial statements that show a true and fair view. The audit has to be seen in the context of a range of interwoven laws, regulations and guidance, all of which promote good corporate governance. (We will look at corporate governance in detail in Chapter 4.)

3.3 The audit opinion and the expectation gap

The primary role of the auditor is to perform an independent examination of the financial statements and to form an opinion. You should be very familiar with this concept from your earlier studies. The audit opinion will provide **reasonable assurance** (a high but not absolute level of assurance) that the financial statements give a true and fair view; it does not provide a certificate that they are completely accurate and free from every error or fraud, no matter how small. ISA 200 explains that absolute assurance is not possible due to inherent limitations of the audit, including those resulting from the following factors:

- The nature of financial reporting; many items involve judgement and assessments of uncertainties
- The use of selective testing
- Inherent limitations of internal control
- The fact that most evidence is persuasive rather than conclusive
- The impracticability of examining all items within a class of transactions or account balance
- The possibility of collusion or misrepresentation for fraudulent purposes
- The fact that the work undertaken by the auditor is permeated by judgement

In some instances an '**expectation gap**' can lead to difficulties arising from the difference between what shareholders and other stakeholders expect an audit to achieve and what it is actually designed to achieve. The public increasingly expect the audit to address a number of issues (such as whether that company will continue trading, or if it is a good investment) but in practical terms, the auditor cannot always make these judgements beyond the requirements of the accounting framework.

Recent changes to the auditor's report have attempted to make such communication more meaningful (such as including details of key audit matters) but the continuing trend of corporate casualties such as Carillion has only served to make the public sceptical of the auditor's work, and the expectation gap remains as wide as ever.

The key judgement made by the auditor is whether the financial statements give a true and fair view. While there is no legal definition for these terms, 'true' and 'fair' are normally taken to mean the following:

Definition

True: The information in the financial statements is not false and conforms to reality.

In practical terms this means that the information is presented in accordance with **accounting standards and law**. The financial statements have been correctly **extracted from the underlying records** and those records reflect the **actual transactions** which took place.

Definition

Fair: The financial statements reflect the commercial substance of the company's underlying transactions and the information is free from bias.

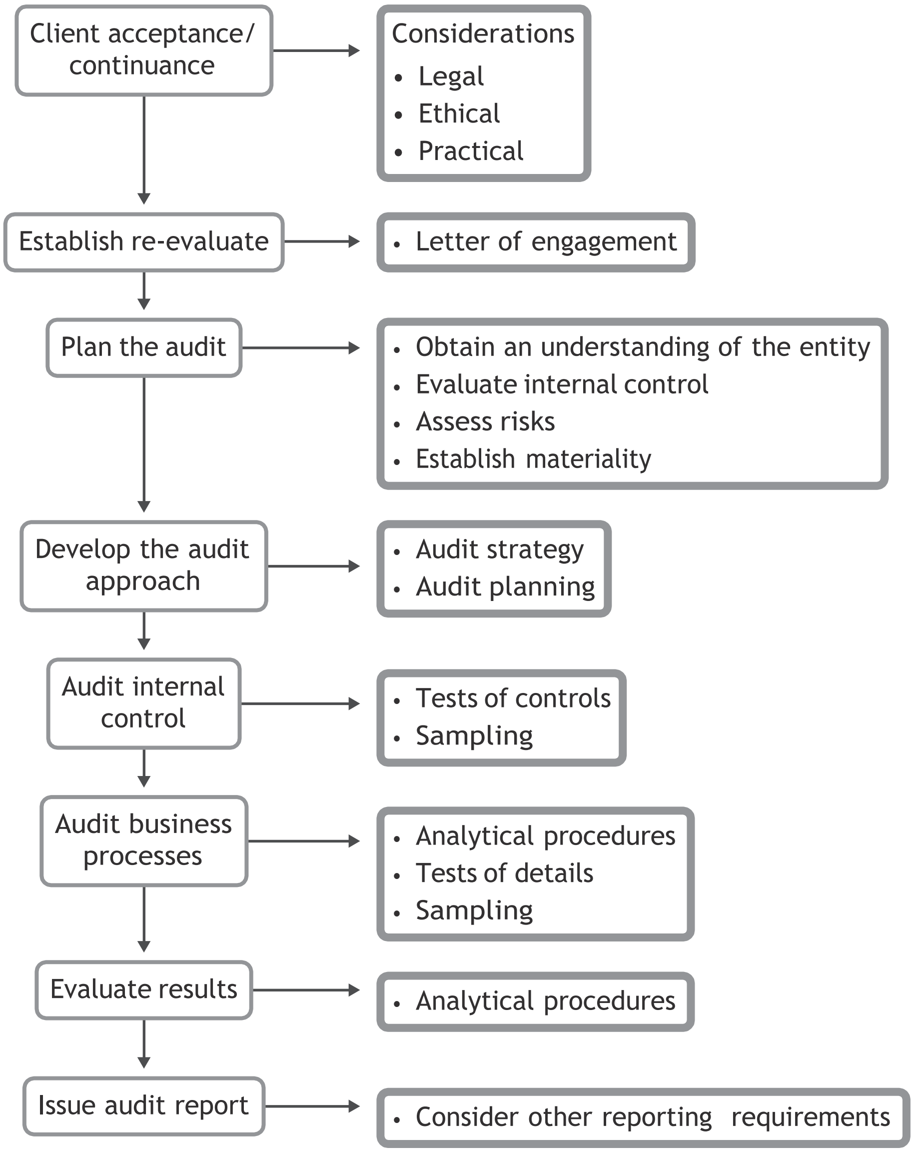
You will have come across examples of the application of **substance over form** in your financial reporting studies.

The problem with making judgements such as these is that they can be called into question, particularly where others have the benefit of hindsight. The major defence that the auditor has in this situation is to show that the work was performed with **due skill and care** and that the judgements made about truth and fairness were reasonable based on the evidence available at the time. We will look at quality management in section 6 of this chapter.

3.4 The audit process

You will have covered the audit process in your earlier studies. The following diagram summarises the key points you should be familiar with. Chapters 5 to 8 of this Workbook cover the audit in more detail.

Figure 1.1: The audit process



Note: ISA 200 requires that the audit should be planned and performed with an attitude of professional scepticism. Professional scepticism is covered in detail in Chapter 5.

Professional skills focus: Assimilating and using information

What stage are you at within the audit process? Remember what you have been told in the scenario (and therefore, by definition, what you still do not know).

3.5 Statutory audit requirement

All Bangladeshi companies must have an audit.

The basic principle is that all companies registered in Bangladesh should be audited.

4 Legal responsibilities of directors and auditors

Section overview

- The Companies Act 1994 contains many responsibilities for both directors and auditors.
- Directors must consider their role carefully, being mindful of the impact that their actions could have on many other stakeholders.
- As well as the financial statements and trading issues, there are also strict rules governing the way that directors interact financially with the company.
- Auditors need to form an independent opinion on the truth and fairness of the financial statements, as well as consider their preparation including any other information that the Companies Act requires.

4.1 Companies Act 1994

The legal responsibilities regarding directors and auditors are currently contained in the Companies Act 1994 (CA 1994). However, the corporate governance guidelines of Bangladesh Securities and Exchange Commission, the issue of capital by the companies listed with any stock exchange in Bangladesh shall be subject to certain further conditions in order to enhance corporate governance in the interest of investors and the capital market.

4.2 Directors' responsibilities

These duties as per CA 1994 are as follows:

(1) There shall be attached to every balance sheet laid before a company in general meeting a report by its board of directors, with respect to-

a) the state of the company's affairs;

b) the amount, if any, which the board proposes to carry to any reserve in such balance sheet;

c) the amount, if any, which the board recommends should be paid by way of dividend;

d) material changes and commitments, if any, affecting the financial position of the company which have occurred between the end of the financial year of the company to which the balance sheet related and the date of the report.

(2) The board's report shall, so far as is material for the appreciation of the state of company's affairs by its members, deal with any changes which have occurred during the financial years:

a) in the nature of the company's business;

b) in the company's subsidiaries or in the nature of the business carried on by them; and

c) generally in the classes of business in which the company has an interest.

(3) The board shall also be bound to give the fullest information and explanations in its report aforesaid on every reservation, qualification or adverse remark contained in the auditor's report.

(4) The board report and any addendum thereto shall be signed by its chairman if the chairman is authorised in that behalf by the board, and where the chairman is not so authorised and, shall be signed by such number of directors as are required to sign the balance sheet and the profit and loss account or the income and expenditure account, of the company by virtue of sub-section (1) and (2) of section 189.

(5) If any person, being a director of a company, fails to take all reasonable steps to comply with the provision of sub-section (1) to (3) or being the chairman, signs the boards report

otherwise than in conformity with the provisions of sub-section (4), he shall, in respect of each offence, be liable to fine which may extend to five thousand aka

These duties as per the corporate governance guideline of Bangladesh Securities and Exchange Commission re as follows:

(i) Industry outlook and possible future developments in the industry.

(ii) Segment-wise or product-wise performance.

(iii) Risks and concerns.

(iv) A discussion on Cost of Goods sold, Gross Profit Margin and Net Profit Margin.

(v) Discussion on continuity of any Extra-Ordinary gain or loss.

(vi) Basis for related party transactions- a statement of all related party transactions should be disclosed in the annual report.

(vii) Utilization of proceeds from public issues, rights issues and/or through any others instruments.

(viii) An explanation if the financial results deteriorate after the company goes for Initial Public Offering (IPO), Repeat Public Offering (RPO), Rights Offer, Direct Listing, etc.

(ix) If significant variance occurs between Quarterly Financial performance and Annual Financial Statements the management shall explain about the variance on their Annual Report.

(x) Remuneration to directors including independent directors.

(xi) The financial statements prepared by the management of the issuer company present fairly its state of affairs, the result of its operations, cash flows and changes in equity.

(xii) Proper books of account of the issuer company have been maintained.

(xiii) Appropriate accounting policies have been consistently applied in preparation of the financial statements and that the accounting estimates are based on reasonable and prudent judgment.

(xiv) International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS), as applicable in Bangladesh, have been followed in preparation of the financial statements and any departure there-from has been adequately disclosed.

(xv) The system of internal control is sound in design and has been effectively implemented and monitored.

(xvi) There are no significant doubts upon the issuer company's ability to continue as a going concern. If the issuer company is not considered to be a going concern, the fact along with reasons thereof should be disclosed.

(xvii) Significant deviations from the last year’s operating results of the issuer company shall be highlighted and the reasons thereof should be explained.

(xviii) Key operating and financial data of at least preceding 5 (five) years shall be summarized.

(xix) If the issuer company has not declared dividend (cash or stock) for the year, the reasons thereof shall be given.

(xx) The number of Board meetings held during the year and attendance by each director shall be disclosed.

(xxi) The pattern of shareholding shall be reported to disclose the aggregate number of shares (along with name wise details where stated below) held by:-

   a) Parent/Subsidiary/Associated Companies and other related parties (name wise details);

   b) Directors, Chief Executive Officer, Company Secretary, Chief Financial Officer, Head of Internal Audit and their spouses and minor children (name wise details);

   c) Executives;

   d) Shareholders holding ten percent (10%) or more voting interest in the company (name wise details).

Explanation: For the purpose of this clause, the expression "executive" means top 5 (five) salaried employees of the company, other than the Directors, Chief Executive Officer, Company Secretary, Chief Financial Officer and Head of Internal Audit.

(xxii) In case of the appointment/re-appointment of a director the company shall disclose the following information to the shareholders:

a) a brief resume of the director;

b) nature of his/her expertise in specific functional areas;

c) names of companies in which the person also holds the directorship and the membership of committees of the board.

CHAPTER 1

4.3 Loan to Director

(1) No company, hereinafter in this section referred to as the lending company, shall make any loan or give any guarantee or provide any security in connection with a loan made by a third party to- (a) any director of the lending company (b) any firm in which any director of the lending company is a partner; (c) any private company of which any director of the lending company is a director or member; or (d) any public company, the managing agent manager or director where of is accustomed to act in accordance with the directions or instruction of any director of the lending company:

Provided that nothing in this section shall apply to the making of a loan or giving of any guarantee or providing any security by a lending company. if-- (i) such company is a banking company or a private company not being a subsidiary of a public company, or if such company as a holding company makes the loan or gives the guarantee or provide the security to its subsidiary; and (ii) the loan is sanctioned by the board of directors of any company and approved by the general meeting and, in the balance sheet, there is a specific mention of the loan, guarantee or security, as the case may be:

Provided further that, in no case the total amount of the loan shall exceed 50% of the paid up value of the shares held by such director in his own name

(2) In the event of any contravention of sub-section (1) every person who is a party to such contravention including in particular any person to whom a loan is made or on whose behalf a guarantee is given to or security provided shall be punishable with the fine which extend to five thousand taka or simple imprisonment for six months in lieu of fine and shall be liable jointly and severally to the lending company for the repayment of such loan or for making good any sum which the lending company may be called up to pay under the guarantee given or security provided by the lending company.

(3) this section shall apply to any transaction represented by a book debt which was from its inception in the nature of a loan

4.4 Auditors' responsibilities

Under the Companies Act 1994, it is the external auditor's responsibility to:

Form an independent opinion on the truth and fairness of the financial statements Confirm that the financial statements have been properly prepared in accordance with the relevant financial reporting framework and the Companies Act 1994

As per section 213 of Companies Act 1994 followings are the power and duties of auditors:

(1) Every auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the company, whether kept at the head office of the company or elsewhere and shall be entitled to require from the officers of the company such information and explanation as the auditor may think necessary for the performance of his duties as auditor.

(2) Without prejudice to the provisions of sub-section (1), the auditor shall, in particular inquire into following namely:

a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members:

b) whether transactions of the company which are represented merely as book-entries are prejudicial to the interests of the company;

c) where the company is not an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities, have been sold at a price less than at which they were purchased by the company;

d) whether loans and advances made by the company have been shown as deposits;

e) whether personal expenses have been charged to revenue account;

f) where it is stated in the books and paper of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

(3) The auditor shall make a report to be presented in the annual general meeting of the company on the accounts, examined by him, and on every balance sheet and profit and loss account and on every other document declared by CA 1994 to be part of or annexed to the balance sheet or profit and loss accounts which are laid before the company in general meeting during his tenure of office and the report shall state whether, in his opinion and to the best of his information and according to the explanation given to him, the said accounts give the information required by the CA 1994 in the manner so required and give a true and fair view-

a) in the case of the balance sheet, of the state of the company's affairs as at the end of its financial year;

b) in the case of the profit and loss account, of the profit or loss for its financial year.

(4) The auditors' report shall also state-

a) whether he has obtained all the information and explanation which to the best of his knowledge and belief were necessary for the purposes of his audit;

b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;

c) whether the company's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns.

(5) There any of the matters referred to in clauses(a) and (b) of sub- section (3) or in clauses (a), (b) and (c) of sub-section (4) are answered in the negative or with a qualification, the auditors' report shall state the reason for the answer.

(6) The Government may, be general or special order, direct that in the case of such class or description of companies as may be specified in the order, the auditors' report shall also include a statement on such matters as may be specified therein.

(7) The accounts of a company shall not be deemed as not having been and the auditors' report shall not state that those accounts have not been, properly drawn up on the ground merely that the company has not disclosed certain matters, of-

a) those matters are such as the company is not required to disclose by virtue of any provision contained in the CA 1994 or any other law for the time being in force; and

b) those provisions are specified in the balance sheet and loss account of the company.

The auditor also has a duty towards other information in documents containing audited financial statements in accordance with ISA 720. The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements.

5 International standards on auditing

Section overview

- The FRC is responsible for Bangladesh auditing standards, known as ISA.
- The International Auditing and Assurance Standards Board (IAASB) issues ISAs.

The FRC adopts and revises ethical standards and auditing standards in response to current developments Ethical standards and guidance are also issued by the ICAB.

5.1.1 Codes and Standards Committee

5.1.2 Current issues from UK market

Despite the UK FRC's mandate to oversee corporate reporting and auditing in the UK, corporate scandals have continued to occur. The most recent significant collapse relates to UK construction company Carillion plc, which went into liquidation in January 2018. It owed over £1 billion to various stakeholders, despite its last audited financial statements indicating no sign of its impending demise. In response to widespread allegations that financial regulation has not improved almost 20 years on from Enron, the UK Government decided to review the UKFRC and in December 2018, the Kingman review of the UK FRC was published.

In his review, Sir John Kingman concluded that the UK FRC was no longer fit for purpose and could not deliver the regulation required to ensure effective corporate reporting, governance and audit. He recommended the replacement of the UK FRC with a new, stronger body (the Audit, Reporting and Governance Authority or ARGA) that would deliver a service that is focused on "consumers of financial information, not producers" (Kingman, 2018).

In conjunction with investigations by the UK Competition and Markets Authority (CMA) into the current state of the UK audit market, the UK Government also commissioned former Chair of the London Stock Exchange, Sir Donald Brydon, to conduct a review of the quality and effectiveness of UK audits. On appointment, Sir Donald was quoted as saying that: "Most people will never read an auditor's opinion on a company's accounts. But tens of millions of people depend on robust and high-quality audits" (Doherty, 2019). The following table shows an overview of the recommendations made by the Brydon Review which carried the title 'Assess, assure and inform - improving audit quality and effectiveness' (Brydon, 2019).

Audit
There should be a new definition of the purpose of an audit: to provide confidence in a company, its officers and its financial statements
Audit should be a separate profession, not seen as part of the accounting profession
Professional judgement should be redefined to include suspicion as well as scepticism
The auditor's report
The term 'true and fair' should no longer be used as it ignores the reliance on estimates and the use of materiality: the term 'present fairly in all material respects' should now only be used
There should be greater continuity between successive reports and greater emphasis given to estimates, other information and any external negative signals

Directors
There should be a rolling three-year audit programme presented by directors to shareholders
A Resilience Statement should be used to report the following: • Short term - similar to the current going concern assessment • Medium term - similar to the existing viability statement • Long term - strategic issues, such as climate change impacts
A Public Interest Statement should report how companies serve the public interest
Stakeholders
Greater shareholder involvement in the audit programme
The audit should more actively consider the role of stakeholders
Greater responsibilities for directors to consult with employees when preparing the financial statements
Auditor to be considered a suitable individual for whistle-blowers to approach
Anti-fraud measures
A directors' statement on the work they have done to prevent and detect fraud
Assurance on this statement by the auditors, including a review of relevant internal controls
Greater use of forensic and fraud training for auditors
Auditor Fraud Panel to consider whether enough has been done to combat fraud
Other steps
Attestation by CEO and CFO on internal controls for financial reporting (similar to the US SOX legislation)
Controls on capital maintenance and dividend levels
Greater transparency by auditors on fees, profitability of engagements, time spent and the circumstances leading to no longer being employed as auditor
Greater use of technology within audits
More responsible use of liability limitation agreements (LLAs) when considering auditor liability and directors' responsibilities
Greater scrutiny of data used in executive remuneration
Reinforcement of the Kingman recommendations on ARGA (such as defining 'high quality audit', a 'Plain English' guide to auditing available online, publicising good audits as well as criticism of bad ones and more formal mechanisms for shareholders and stakeholders to raise concerns.

(Source: Brydon, D. (2019) Assess, assure and inform: Improving audit quality and effectiveness. [Online] Available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/ 852960/brydon-review-final-report.pdf [Accessed 27 May 2022])

In March 2021, the Department for Business, Energy and Industrial Strategy (BEIS) issued a white paper called *Restoring trust in audit and corporate governance: proposals on reforms* seeking views from stakeholders on the CMA, Brydon and Kingman proposals in relation to audit, financial reporting, governance and regulation with the aim of improving the overall regulatory landscape for all these essential areas. Inevitably, the structure and operation of the audit market would also be addressed by this process.

Consultation on the BEIS white paper ran from March to July 2021. In March 2022, the FRC published their three-year plan which indicated that ARGA would be fully operational by 2025. This was followed soon after by confirmation from the UK Government that ARGA (now fully funded by a mandatory levy) would play a key part in its overall regulatory framework for audit, reporting and governance that would reduce the risks of further damaging corporate collapses like Carillion and BHS – some of the key changes planned are as follows:

- greater control over auditors, including a ban on failing audit firms from being able to review the financial statements of large companies and the separation of their audit and non-audit functions;
- minimising the reporting burdens for many companies, especially those at the smaller end, while allowing more companies to fall under the scope and protection of ARGA;
- greater scrutiny over directors as well as the power to fine them for any lack of transparency over a company's performance and prospects;
- highlighting the need for clawbacks from directors and shareholders when companies are in financial difficulty and cannot afford to pay out bonuses and dividends; and
- greater representation of audit firms from outside of the Big Four for FTSE 350 listed companies (plus a market share cap for auditors that the Business Secretary can impose if required).

Clearly there is **significant change ahead**: for the purposes of your exam, while you can assume that the regulator is still the FRC, it is expected that you will also have knowledge of these ongoing developments.

There is also an ongoing debate about the way that going concern should be assessed with the ongoing effects of the COVID-19 pandemic and other geo-political influences in mind to avoid future losses that could have been foreseen with clearer levels of disclosure about the risk of corporate failure. This will no doubt require greater input from auditors, directors and audit committees as well as guidance from regulators and governments to reach a solution that protects all stakeholders.

One of the key challenges facing the UK FRC as the regulator of financial reporting and governance in the UK is striking the right balance between the need to impose controls on businesses in order to protect stakeholders and the need to support how businesses thrive and generate economic benefits to those same stakeholders. This is illustrated by the way that going concern is currently under scrutiny – too much scepticism of an entity's prospects and it is destined to fail, but insufficient scrutiny of possible red flags and we could have another Carillion on our hands. You will cover the way that both audits and reviews of financial information are currently being influenced by this ongoing debate in subsequent chapters.

Given the impact of global turbulence on the UK and its partners, uncertainty for both preparers and users of financial statements continues, although it still seems certain that the FRC and its successor will face radical change.

5.1 Interaction between FRC and IAASB Standards

The IAASB was set up by the International Federation of Accountants (IFAC), which nominates a majority of its members – others are nominated by the Forum of Firms – to issue professional standards (such as those related to audits, reviews, related services and quality management). ISAs are used for the audit of **historical financial information**.

In **exceptional circumstances**, an auditor may judge it necessary to **depart from an ISA** in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure. In Bangladesh ISAs are adopted by the FRC.

The system for creating an ISA (UK) currently works as follows:

5.2 IAASB Projects

The IAASB regularly makes improvements to its standards as a result of a number of ongoing projects.

For example, in 2015, a series of new and revised standards were issued on auditor reporting. The most notable change was the introduction of ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report* which requires auditors of listed companies to communicate Key Audit Matters.

More recently, changes have been made in relation to the auditor's responsibilities for other information accompanying financial statements and the audit of accounting estimates and related disclosures.

At the time of writing the IAASB is conducting projects that consider the identification and assessment of risks of material misstatement, group auditing, and audit evidence.

Definition

Public interest entity:

The definition of a Public Interest Entity (PIE) in Bangla is outlined in section 2(8) of the Financial Reporting Act, 2015 (referred to as the "Act"). Additionally, the FRC has established the criteria for PIE through four official Gazette Notifications. It is important to note that an official English translation of the PIE definition by the FRC has not been released yet. As a result, the following represents an unofficial English translation of the definition of PIE in Bangladesh, which is based on the provisions of the Act and the Gazette Notifications issued by the FRC.

Public Interest Entity means –

A. An entity which shall meet any one of the following criteria, namely:

1. Bank-Company as defined in the Banking-Companies Act, 1991;
2. any entity that is involved in issuing securities and that is required to file a report with the Securities and Exchange Commission in accordance with the Bangladesh Securities and Exchange Commission Act of 1993;
3. Financial Institution as defined in the Financial Institutions Act, 1993;
4. Microfinance Institution as defined in the Microcredit Regulatory Authority Act, 2006;
5. Insurer as defined in the Insurance Act, 2010;
6. any entity that has surpassed the threshold of Tk500 million in annual revenue during the preceding fiscal year, as determined by the Council through an official Gazette notification (as per SRO-34 PIE, based on revenue).
7. any entity that meets either of the following two conditions at the conclusion of the prior fiscal year, provided that:
    a) it appoints at least 50 individuals as specified in the Rule 2023 issued in this regard.
    b) its total assets surpass the Tk300 million threshold established by the Council through an official Gazette notification (as per SRO-35 PIE based on total assets) and
    c) the total liability, excluding shareholder equity, goes beyond the Tk100 million limit determined by the Council through an official Gazette notification (as per SRO-36 PIE based on liability).

B. The following institutions fulfilling the criteria mentioned in (A) above shall also be included, namely:

8. state-owned companies or commercial entities;
9. statutory authority;
10. a non-governmental organization conducting voluntary activities in the private sector; and
11. any other similar organization or institution;

Following recent developments in ethical standards (see Chapter 3) the term other entity of public interest (OEPI) has emerged. While still subject to interpretation, the term essentially refers to entities which do not meet the definition of a public interest entity but which are still considered to have public interest aspects (such as a pension fund).

5.3 The global outlook

Every generation will feel that they are living in the most interesting of times, but as we navigate the third decade of the 21st century, the global outlook is becoming increasingly uncertain and volatile, not least due to the COVID-19 pandemic and various wars. For example:

Political	Economic
• The rise of populist, nationalist politics and a push against the status quo (such as the rise of far-right politics in certain countries) • Greater calls for independence and self-determination	• A global realignment following the financial crash of 2008, which has stifled growth, eroded confidence and encouraged trade wars • Stagnation on global efforts to close the gap between rich and poor leading to social unrest
Social	**Technological**
• The increasing impact of climate change and the need to respond effectively regardless of the costs • Shifting demographics (eg, the rise of the #MeToo movement) highlighting the importance of diversity	• A shift towards a more digital age, with the associated disruption to traditional industries (including accountancy) • The adoption of new technologies (eg, big data, blockchain and artificial intelligence) and the opportunities they create

What does this mean for accountants? The issues presented here paint a challenging picture, but the profession has always been able to respond to the world around it, so demonstrating skills such as awareness and adaptability will be crucial for the survival of the profession.

Professional skills focus: Concluding, recommending and communicating

You may be asked to discuss the ongoing developments in both corporate reporting and auditing. You should ensure you have not only studied these developments but that you can also communicate your thoughts in an effective and efficient manner.

6 Audit quality management

Section overview

- Quality management procedures should be adopted:
  - at the firm level; and
  - on an individual audit.
- Audit quality should be actively managed by the engagement partner.
- Professional bodies also have a responsibility to develop quality management standards and monitor compliance.
- Audit documentation is an important part of quality management.
- It provides evidence of work done to support the audit opinion.
- Significant matters must be documented.
- Audit working papers should be reviewed.

6.1 Principles and purpose

Audit quality is not defined in law or through regulations, nor do auditing standards provide a simple definition.

Although each stakeholder in the audit will give a different meaning to audit quality, at its heart it is about delivering an appropriate professional opinion supported by the necessary evidence and objective judgements.

Many principles contribute to audit quality including good leadership, experienced judgement, technical competence, ethical values and appropriate client relationships, proper working practices and effective quality management and monitoring review processes.

The standards on audit quality provide guidance for firms on how to achieve these principles.

6.2 Quality management at a firm level

The fact that auditors follow ISAs provides a general quality management framework within which audits should be conducted. There are also specific quality management standards. ISQM 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or other Assurance or Related Services Engagements* deals with quality management at a firm level. You may have studied ISQM 1 in Audit and Assurance at the Professional Level.

ISQM 1 identifies the following **eight components** of the firm's system of quality management.

- **The firm's risk assessment process**

  A system of quality management must be established by the firm in order to be able to achieve its quality objectives and manage quality risks (in other words, the risk that the firm's quality may be under threat). This is usually achieved by implementing a series of policies and procedures that serve as a system of quality management.

- **Governance and leadership responsibilities for quality within the firm**

  The standard requires that the firm implements policies such that the internal culture of the firm is one where quality is considered essential. Such a culture must be inspired by the leaders of the firm, who must sell this culture in their actions and messages. In other words, the entire business strategy of the audit firm should be driven by the need for quality in its operations. Overall responsibility for quality within the firm rests with the senior leadership (such as a managing partner) while operational responsibilities fall within the remit of other personnel (so the engagement partner or key audit partner is responsible for quality on any given engagement).

- **Ethical requirements**

  Policies and procedures should be designed to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements and in particular independence requirements. Firms can decide to adopt their own ethical guidance that goes beyond the minimum standards laid down by the current regulatory regime.

- **Acceptance and continuance of client relationships and specific engagements**

  A firm should only accept, or continue with, a client where it has considered the **integrity** of the client, it is **competent** to perform the engagement and has the capabilities, including time and resources, to do so, and it can **comply with ethical requirements**, including appropriate independence from the client.

  ISQM 1 does not expect acceptance and continuance decisions to be based on commercial priorities.

  For the audit of a public interest entity the firm must assess whether the firm complies with the FRC Revised Ethical Standard requirements on audit fees and prohibition of the provision of non- audit services requirements.

- **Engagement performance**

  The firm should take steps to ensure that engagements are performed correctly; that is, in accordance with standards and guidance. Ensuring good engagement performance involves a number of issues, such as direction, supervision and review, consultation and resolution of disputes.

  The firm should have policies and procedures to determine when an **engagement quality review** will be necessary for an engagement. This will include all audits of financial statements for listed companies and in Bangladesh also applies to public interest entities and other higher risk engagements. When required, such a review must be completed **before the report is signed**.

  For audits of financial statements of public interest entities the **engagement quality reviewer** must be an individual who possesses the competence, capabilities, authority and independence necessary to make this process effective. **ISQM 2 *Engagement Quality Reviews*** is the applicable standard here and specifies the following objectives:

  - appoint an eligible engagement quality reviewer who is not part of the engagement team; and
  - perform an objective evaluation of the significant judgements made by the engagement team and the conclusions they reached from those judgements.

  The engagement quality review is expected to apply legal, professional and regulatory standards and requirements and determine any areas of non-compliance (including any that do not comply with the firm's own system of quality management). The review will be conducted throughout the course of the engagement and include issues such as:

  - reviewing documentation produced by both the engagement team and the firm in relation to the engagement and any possible deficiencies identified;
  - discussing significant matters and judgements from the engagement;
  - evaluating decisions made for evidence of logic, scepticism, ethical compliance, consultation and sufficient involvement of the engagement partner; and
  - reviewing audit documentation to ensure it satisfactorily reflects the work necessary to support the successful implementation of ISQM 2.

- **Resources**

  The firm needs to have policies and procedures in place regarding the resources necessary for engagements to support quality management systems, including **human resources** (including all staff and the engagement partner), **technological resources** (such as data analytics software), **intellectual resources** (such as prescribed audit methodologies) and the use of **service providers** (for example, anyone involved in a consultative or expert capacity).

- **Information and communication**

  The firm needs to have a system in place that supports quality management for effective assurance work in terms of data storage and retrieval, information security, communication across and between teams and maintaining appropriate levels of confidentiality.

- **Monitoring and remediation**

  The standard states that firms must have policies in place to ensure that their quality management procedures are relevant, adequate, and operating effectively. In other words, they must **monitor their system of quality management**. Monitoring activity should be reported on to the management of the firm on an annual basis. **Remedial action**, if required, should be implemented to address any deficiency promptly.

  There are two types of monitoring activity, an **ongoing evaluation** of the system of quality management and **cyclical inspection** of a selection of completed engagements. An ongoing evaluation might include such questions as "has it kept up to date with regulatory requirements?".

  An inspection cycle would usually fall over a period such as three years, in which time at least one engagement per engagement partner would be reviewed.

6.3 Quality management on an individual audit

You will have studied this issue in the previous Audit and Assurance exam. A summary of the key points in ISA 220 (Revised), *Quality Management for an Audit of Financial Statements* is provided below.

6.3.1 Policies and procedures

ISA 220 (Revised) states that the objective of the auditor is to implement quality management procedures at the individual engagement level. The **engagement partner** is ultimately responsible for quality management on an individual engagement.

The policies and procedures for quality management on individual audits parallel those for the firm outlined above. For example, ethical requirements must be considered. In addition, however, of particular significance for individual audits are the procedures of **direction, supervision and review**.

(a) Direction

At the planning stage, but also during the audit, the engagement partner ensures that the members of the engagement team are informed of:

- their responsibilities
- the objectives of the work to be performed
- the nature of the entity's business
- risk issues
- problems that may arise
- detailed approach to the audit engagement

(b) **Supervision**

Supervision includes:

- tracking the progress of the audit engagement;
- considering the capabilities of individual members of the engagement team and that they understand their instructions;
- addressing issues that arise and modifying the audit approach if appropriate; and
- identifying matters for consultation or consideration by more experienced members of the audit engagement.

(c) **Review**

Reviewing concerns the inspection of work by engagement members by more senior members of the same engagement. This includes ensuring that:

- the work has been carried out in accordance with professional and regulatory requirements;
- significant matters have been raised for further consideration;
- appropriate consultations have taken place and have been documented;
- where appropriate the planned audit work is revised;
- the work performed supports the conclusions;
- the evidence obtained is sufficient and appropriate to support the audit opinion; and
- the objectives of the engagement have been achieved.

The revised ISA also includes specific guidance in relation to the **engagement quality review** for audits of the financial statements of public interest entities. The purpose of the engagement quality review is to provide an objective evaluation, on or before the date of the auditor's report, of the significant judgments the engagement team made and the conclusions it reached in formulating the auditor's report. As part of their responsibilities for the engagement overall, the engagement partner needs to confirm that they have dedicated sufficient time to the engagement in order to be able to be considered responsible enough to sign off on that engagement: agreeing with the outcome of the engagement quality review is one such example of this. In particular the review must consider the following:

(1) The independence of the firm from the entity

(2) The significant risks and measures taken to manage them

(3) Reasoning in relation to materiality and significant risks

(4) Any request for advice from external experts and the implementation of the advice

(5) The nature and scope of corrected and uncorrected misstatements

(6) The subjects discussed with the audit committee/management/supervisory bodies/competent authorities/third parties

(7) Whether information on the audit file supports the opinion in the auditor's report and additional report to the audit committee

(d) **Hot and cold reviews**

Hot file reviews are carried out before the auditor's report is issued. Their purpose is to identify any weaknesses in the application of audit procedures or to assess if results from audit procedures have been misinterpreted. They can be done for higher risk audits. Such reviews are usually undertaken by an audit partner not connected with the audit.

Cold file reviews are carried out after the auditor's report has been issued. Their primary purpose is to determine compliance with ethical and auditing standards and relevant legislation, and to consider whether the audit work has been carried out in accordance with the firm's own procedures, thereby identifying any weaknesses in the firm's quality management procedures, and how these can be improved upon. Cold reviews are carried out by suitably qualified individuals who are independent of the client and have had no involvement in the audit work.

Small firms and sole practitioners may be required to arrange external reviews at least once every three years if there is no suitable reviewer available from within the organisation. A cold file review will result in identification of any areas of non-compliance and the formulation of a suitable action plan with the firm.

6.4 UK FRC Audit Quality Thematic Reviews

The following section represents audit quality related notable events from UK market.

In March 2017, the FRC issued *Audit Quality Thematic Review: Firms' audit quality control procedures and other quality initiatives* to support the continuous improvement in audit quality in the UK. Some new areas of best practice were identified (such as adopting different 'lines of defence' for a firm's procedures to interact effectively) but also some areas for further work (such as more senior members of the audit team reviewing audit work) arose too.

Note: The term 'quality control' was superseded when ISQM (UK) 1 and 2 and ISA (UK) 220 (Revised) were all published in the UK in July 2021 and 'quality management' was subsequently adopted across the profession. Throughout this Workbook, although you may come across guidance published prior to this date that contains reference to the term 'quality control', you can assume that it means the same thing as 'quality management'.

This was followed in May 2018 by another Thematic Review called *Firms' activities to establish, promote and embed a culture that is committed to delivering consistently high quality audits*. In this publication, the FRC defined culture as "a combination of the values, attitudes and behaviours manifested by an organisation in its operations and relations with its stakeholders".

While many might seem sceptical about the role that the FRC in particular could play in addressing something as complex as culture among different firms, the messages contained within these reports have outlined the need for a greater awareness of the following cultural factors that can improve the scope and quality of audits in the UK:

- Prioritising values such as the fundamental ethical principles
- Recognising that good audits are necessary to support society in general
- Promoting good quality work practices in auditing as much as punishing poor quality work
- Using root cause analysis to identify cultural factors that led to good and bad quality audit work
- Using independent non-executives to monitor the successful adoption of desired culture (FRC, 2018)

The FRC continues to address quality as part of its regulatory role. In July 2020 it published its *Annual enforcement review* which found that both ethical and auditing standards were not always being followed, contributing to some instances of audit failure due to not obtaining sufficient appropriate audit evidence and displaying inadequate levels of professional scepticism. This was echoed in November 2020 by *Developments in audit 2020* when the FRC reported inconsistent levels of audit quality on higher risk audits, predominantly due to insufficient challenge of management in the following areas:

- complex and forward-looking judgements (such as goodwill impairment)
- assessment of an entity's going concern status and plans to address perceived uncertainties

In addition, the FRC raised concern over several instances when group audit teams had failed to demonstrate how they had assessed the work undertaken by component audit teams. There were also concerns over the approach adopted by firms when reviewing audit work as part of their own internal quality control processes (FRC, 2020).

The FRC *Developments in audit 2021* report concluded that the number of audits inspected which required either improvement or significant improvement had not improved and was still at a level that was not considered acceptable by the FRC.

Interactive question 2: Addystone Fish

You are an audit senior working for the firm Addystone Fish. You are currently carrying out the audit of Wicker Ltd, a manufacturer of waste paper bins. You are unhappy with Wicker's inventory valuation policy and have raised the issue several times with the audit manager. He has dealt with the client for a number of years and does not see what you are making a fuss about. He has refused to meet you on site to discuss these issues.

The former engagement partner to Wicker retired two months ago. As the audit manager had dealt with Wicker for so many years, the other partners have decided to leave the audit of Wicker largely in his hands.

Requirement

Comment on the situation outlined above. See **Answer** at the end of this chapter.

6.5 Audit documentation

Audit documentation is a key part of the overall quality management framework during the course of an audit. All audit work must be documented: the working papers are the **tangible evidence of all work done in support of the audit opinion**. ISA 230 (Revised June 2016), *Audit Documentation* provides guidance on this issue.

In your previous studies, you have learnt the practical issues surrounding how audit working papers should be completed. The key general rule to remember concerning what to include in a working paper is:

"What would be sufficient to enable an experienced auditor, having no previous connection with the audit to understand the nature, timing, and extent of the audit procedures performed to comply with the ISAs and applicable legal and regulatory requirements and the results of the audit procedures and the audit evidence obtained, and significant matters arising during the audit and the conclusions reached thereon, and significant professional judgements made in reaching those conclusions." (ISA 230 para.8)

Review of audit working papers is important, as it allows a more senior auditor to **evaluate the evidence obtained** during the course of the audit for sufficiency and reliability, so that more evidence can be obtained to support the audit opinion, if required. It is an important quality management procedure. ISA 500 *Audit Evidence* is relevant here.

Interactive question 3: Documentation (revision)

Viewco is a manufacturer of TVs and Blu-ray players. It carries out a full physical inventory count at its central warehouse every year on 31 December, its financial year end. Finished goods are normally of the order of £3 million, with components and work in progress normally approximately £1 million.

You are the audit senior responsible for the audit of Viewco for the year ending 31 December 20X1. Together with a junior member of staff, you will be attending Viewco's physical inventory count.

Requirements

3.1 Explain why it is necessary for an auditor to prepare working papers.

3.2 State, giving reasons, what information the working papers relating to this inventory count attendance should contain.

See **Answer** at the end of this chapter.

Interactive question 4: TrucksToGo Ltd

You are the audit senior on the audit of TrucksToGo Ltd. You are supervising the work of a relatively inexperienced audit junior. The junior has been carrying out audit procedures on the assertions of completeness and existence of non-current assets. According to the junior, audit procedures have been completed and the memo below has been produced outlining some of the issues found during the audit.

Memo: Issues identified during audit

The directors have confirmed that there are no further non-current assets to include in the financial statements. This representation was received in a meeting with the Finance Director and recorded on the audit file at this time.

Part of the existence work on non-current assets included obtaining a sample of assets from the asset register and then physically verifying those assets. Unfortunately, a significant number of assets were not available for verification – the vehicles were in use by the company and therefore not on the premises. As an alternative, vehicles on the premises were agreed back to the asset register.

A number of vehicles were noted on the company premises in a poor state of repair; for example, engines missing. On inquiry, the vehicle manager confirmed that the vehicles were under repair. I am therefore happy that the vehicles belonged to the company and no further action is necessary.

I have reached the conclusion that all non-current assets are correctly stated and valued in the financial statements.

Requirement

Explain to the junior why the evidence collected is insufficient, and detail the action necessary to complete the audit procedures. Refer to your objectives in reviewing audit documentation as a format for your answer.

See **Answer** at the end of this chapter.

7 Laws and regulations

Section overview

The auditor is responsible for obtaining sufficient appropriate audit evidence regarding compliance with laws and regulations that have a direct effect on the financial statements

7.1 Revision

The responsibilities of the auditor for laws and regulations are covered in ISA 250 (Revised), Consideration of Laws and Regulations in an Audit of Financial Statements. You have covered the principles contained in this standard in your earlier studies. A summary of the key points is included below.

The objectives of the auditor are:

(a) To obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements;

(b) To perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements; and

(c) To respond appropriately to non-compliance or suspected non-compliance with laws and regulations identified during the audit.

(ISA 250.11)

An audit **cannot** detect non-compliance with **all** laws and regulations.

Definition

Non-compliance: Refers to acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity, or on its behalf, by those charged with governance, management or employees. Non-compliance does **not** include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management or employees of the entity. (ISA 250.12)

7.2 Responsibility of management for compliance

Management are responsible for ensuring that a client's operations are conducted in accordance with laws and regulations.

The following policies and procedures, among others, may assist management in discharging its responsibilities for the prevention and detection of non-compliance.

- **Monitor legal requirements** and ensure that operating procedures are designed to meet these requirements.
- **Institute and operate** appropriate systems of **internal control**, including internal audit and an audit committee.
- **Develop, publicise and follow a code of conduct**.
- Ensure that **employees** are properly **trained** and **understand the code of conduct**.
- **Monitor compliance** with the code of conduct and act appropriately to **discipline** employees who fail to comply with it.
- **Engage legal advisers** to assist in monitoring legal requirements.
- **Maintain a register** of significant laws with which the entity has to comply within its particular industry and a record of complaints.

7.3 Responsibility of the auditors

The auditor's responsibilities depend on whether or not the law or regulation has a direct effect on the financial statements as follows:

"The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements." (ISA 250.14)

These laws and regulations may relate to:

- the form and content of financial statements;
- accounting for transactions under government contracts;
- laws determining the circumstances under which a company is prohibited from making a distribution except out of available profits; and
- laws which require auditors expressly to report non-compliance, such as not keeping proper records.

For other laws and regulations the auditor is required to perform audit procedures to help identify instances of non-compliance. Procedures would include inquiring of management and those charged with governance and inspecting correspondence with relevant licensing or regulatory authorities.

Written representations from management are also important. The standard requires the auditor to obtain written representations. (ISA 250.17)

7.4 Procedures when non-compliance is discovered

The ISA requires the following approach.

If the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance, the auditor shall obtain:

- understanding of the nature of the act and the circumstances in which it has occurred; and
- further information to evaluate the possible effect on the financial statements. (ISA 50.19)

When evaluating the possible effect on the financial statements, the auditor should consider:

- the **potential financial consequences**, such as fines, penalties, damages, threat of expropriation of assets, enforced discontinuation of operations and litigation;
- whether the **potential financial consequences** require **disclosure**; and
- whether the potential financial consequences are so serious as to call into question the **true and fair view** (fair presentation) given by the financial statements.

If the auditors suspect there may be non-compliance they should discuss the matter with management and those charged with governance.

Such discussions are subject to the laws concerning 'tipping off'. If information provided by management is not satisfactory, the auditor should consult the entity's lawyer and, if necessary, their own lawyer on the application of the laws and regulations to the particular circumstances.

7.5 Reporting of non-compliance

7.5.1 To management

ISA 250 requires the following:

Unless all of those charged with governance are involved in management of the entity, and therefore are aware of matters involving suspected non-compliance already communicated by the auditor, the auditor shall communicate with those charged with governance matters involving non-compliance with laws and regulations that come to the auditor's attention during the course of the audit, other than when the matters are clearly inconsequential.

If, in the auditor's judgement, the non-compliance is believed to be intentional and material, the auditor shall communicate the matter to those charged with governance as soon as practicable.

If the auditor suspects that management or those charged with governance are involved in non- compliance, the auditor shall communicate the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or supervisory board. Where no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, the auditor shall consider the need to obtain legal advice.

(ISA 250.23–.25)

7.5.2 To the users of the auditor's report

If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall, in accordance with ISA 705, express a qualified opinion or an adverse opinion on the financial statements.

If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit in accordance with ISA 705.

If the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by management or those charged with governance, the auditor shall evaluate the effect on the auditor's opinion in accordance with ISA 705. (ISA 250.26–.28)

7.5.3 To regulatory and enforcement authorities

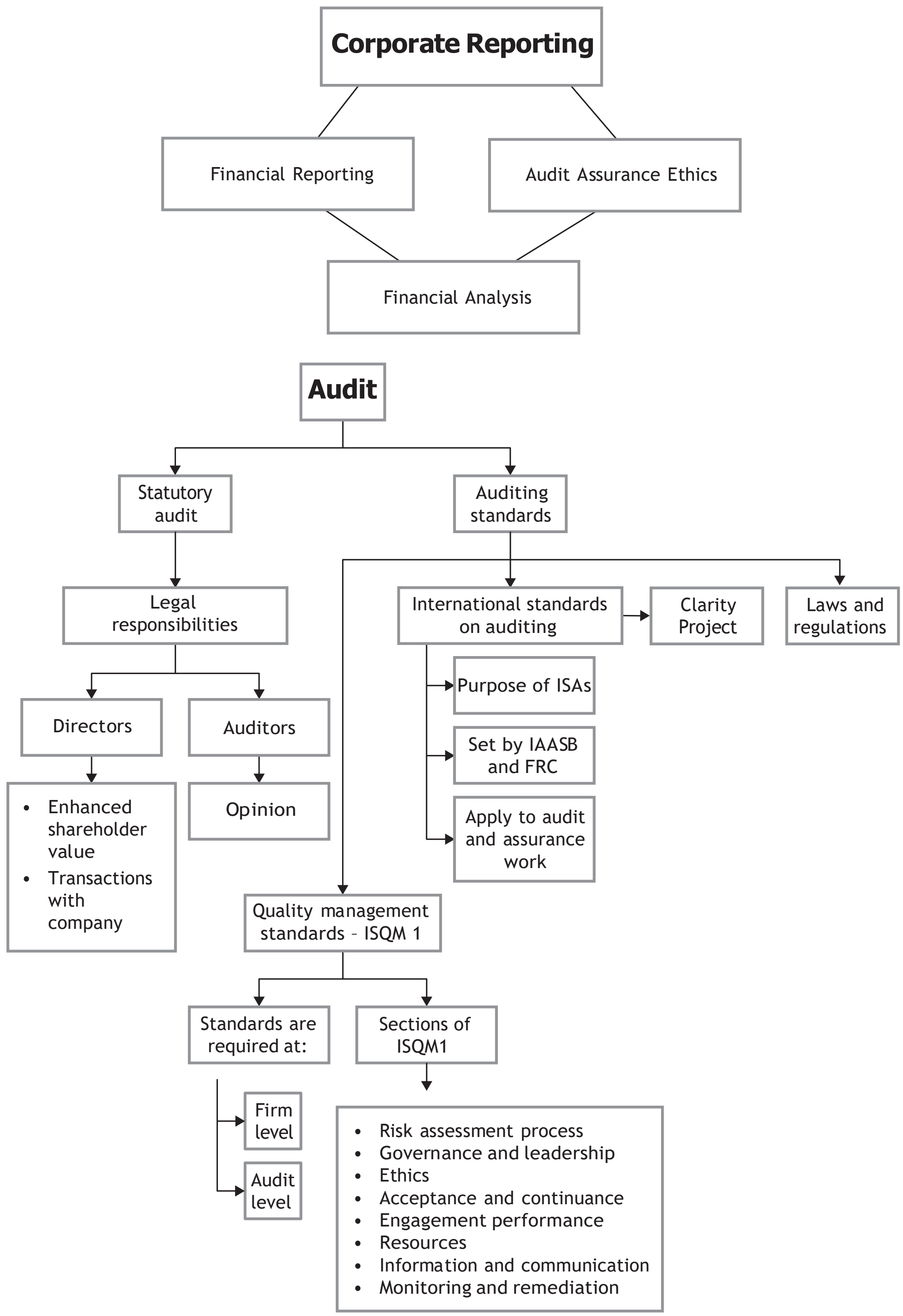
Confidentiality is an issue again here, but it may be overridden by the law, statute or the courts of law. The auditor should obtain legal advice. If the auditor has a statutory duty to report, a report should be made without delay.

Alternatively, it may be necessary to make disclosures in the public interest. In practice it will often be extremely difficult for an auditor to decide whether making a disclosure in the public interest is warranted. The auditor should obtain professional advice.

7.6 Withdrawal from the engagement

As is the case for fraud or error, withdrawal may be the only option if the entity does not take the remedial action the auditor thinks is necessary, even for non-material matters.

Summary


Corporate Reporting
Financial Reporting
Audit Assurance Ethics
Financial Analysis
Audit
Statutory audit
Auditing standards
Legal responsibilities
International standards on auditing
Clarity Project
Laws and regulations
Purpose of ISAs
Set by IAASB and FRC
Apply to audit and assurance work
Directors
Auditors
Enhanced shareholder value
Transactions with company
Opinion
Quality management standards – ISQM 1
Standards are required at:
Sections of ISQM1
Firm level
Audit level
Risk assessment process
Governance and leadership
Ethics
Acceptance and continuance
Engagement performance
Resources
Information and communication
Monitoring and remediation

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Do you understand what is meant by the term 'corporate reporting'?
2.	Can you remember the various phases of an audit and explain what each one is for?
3.	Can you distinguish between the responsibilities of directors and auditors?
4.	Can you discuss current issues that affect both corporate reporting and auditing right now?
5.	Can you describe and explain the various quality management mechanisms that should be present in an audit firm?
6.	Do you know how to report various instances of non-compliance with laws and regulations and to whom this reporting should be directed?

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
LaFa plc	This is useful practice for you in two ways: firstly, it is testing your knowledge of the subject matter on quality management which you need to understand, and secondly, it is presented in the form of a scenario which you will need to apply your knowledge to.
Bee5	You can test your understanding of the audit approach by applying what you have learned to this short scenario. What changes might cause you concern?

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios that will help you improve your knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Vacance plc	Sometimes the question contains so much information it is difficult to know where to start. Use this question to practise interrogating the exhibits for matters that relate to the audit quality on show.
Newpenny	Exhibit 1 asks for a change to the audit approach. Do you think this is a good idea?
Jupiter	Consider the issue of non-compliance with laws and regulations from Exhibit 3 – what are the potential implications of this for the audit?

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving on to the next chapter.

Technical reference

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1 What is financial reporting?

- Financial reporting is the provision of financial information about a reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

  Corporate reporting is a broader concept, which covers other reports, such as audit or environmental reports – **Conceptual Framework for Financial Reporting (OB2)**
- Financial statements comprise statement of financial position, statement of profit or loss and other comprehensive income, statement of changes in equity, statement of cash flows and notes. – **IAS 1 (10)**

2 Purpose and use of financial statements

- Users' core need is for information for making economic decisions. – **Concept Frame (OB2)**
- Objective is to provide information on financial position (the entity's economic resources and the claims against it) and about transactions and other events that change those resources and claims. – **Concept Frame (OB12**)
- Financial position: – **Concept Frame (OB13)**
  - Resources and claims

  - Help identify entity's strengths and weaknesses
  - Liquidity and solvency
- Changes in economic resources and claims: – **Concept Frame (OB15-16)**
  - Help assess prospects for future cash flows
  - How well have management made efficient and effective use of the resources
- Financial performance reflected by accrual accounting. – **Concept Frame (OB17)**
- Financial performance reflected by past cash flows. – **Concept Frame (OB20)**

3 ISA 200

- Purpose of an audit – **ISA 200.3**
- General principles of an audit – **ISA 200.14–.24**

4 ISQM 1

- Objective – **ISQM 1.14**
- Components of a system of quality management – **ISQM 1.6**
- The firm's risk assessment process – **ISQM 1.23-.27**
- Governance and leadership – **ISQM 1.28**
- Relevant ethical requirements – **ISQM 1.29**
- Acceptance and continuance issues – **ISQM 1.30**
- Engagement performance – **ISQM 1.31**
- Resources – **ISQM 1.32**
- Information and communication – **ISQM 1.33**
- Monitoring and remediation – **ISQM 1.35–.56**

5 ISQM 2

- Objective – **ISQM 2.12**
- Requirements – **ISQM 2.14-.16**
- Engagement quality reviewers – **ISQM 2.17-.23**
- Performance of the review – **ISQM 2.24-.27**
- Documentation – **ISQM 2.28-.30**

6 ISA 230

- Purposes of audit documentation. – **ISA 230.2–.3**
- Should enable an experienced auditor to understand the procedures performed, the results and evidence obtained and significant matters identified. – **ISA 230.8–.8-1**
- Auditors must document discussions of significant matters with management. – **ISA 230.10**
- Inconsistencies regarding significant matters must be documented. – **ISA 230.11**
- Departures from relevant requirements in ISAs must be documented. – **ISA 230.12**
- The identity of the preparer and reviewer must be documented. – **ISA 230.9**

7 ISA 250

- Categories of laws and regulations – **ISA 250.6**
- Objectives – **ISA 250.11**
- Auditor's responsibilities – **ISA 250.13–.14**
- Reporting – **ISA 250.23**

Self-test questions

Answer the following questions.

1 Performance and position

Explain the terms 'performance' and 'position', and identify which of the financial statements will assist the user in evaluating performance and position.

2 LaFa plc

The WTR audit firm has 15 partners and 61 audit staff. The firm has offices in three cities in one country and provides a range of audit, assurance, tax and advisory services. Clients range from sole traders requiring assistance with financial statement production to a number of small plcs – although none is a quoted company.

LaFa plc is one of WTR's largest clients. Due to the retirement of the engagement partner from ill health last year, LaFa has been appointed a new engagement partner. WTR provides audit services as well as preparation of taxation computations and some advisory work on the maintenance of complicated costing and inventory management systems. The audit and other services engagement this year was agreed on the same fee as the previous year, although additional work is required on the audit of some development expenditure which had not been included in LaFa's financial statements before. Information on the development expenditure will be made available a few days before audit completion 'due to difficulties with cost identification' as stated by the Finance Director of LaFa. LaFa's management were insistent that WTR could continue to provide a similar level of service for the same fee.

Part way through the audit of WTR, Mr W, WTR's quality management partner, resigned to take up a position as Finance Director in SoTee plc, LaFa's parent company. SoTee is audited by a different firm of auditors. Mr W has not yet been replaced, as the managing board of WTR has yet to identify a suitable candidate. Part of the outstanding work left by Mr W was the implementation of a system of ethical compliance for all assurance staff whereby they would confirm in writing adherence to the Code of Ethics and confirm lack of any ethical conflict arising from the code.

Requirement

Identify and explain the risks which will affect the quality management of the audit of LaFa. Suggest how the risks identified can be reduced.

3 Bee5

You are the audit manager in charge of the audit of Bee5, a construction company. The client is considered to be low risk; control systems are generally good and your assurance firm, Sheridan & Co, has normally assisted in the production of the financial statements providing some additional assurance of the accuracy and completeness of the statements.

During the initial planning meeting with the client you learn that a new Finance Director has been appointed and that Bee5 will produce the financial statements this year; the services of your firm's accounts department will therefore not be required. However, Bee5 has requested significant assurance work relating to a revision of its internal control systems. The current accounting software has become less reliable (increased processing time per transaction and some minor data loss due to inadequate field sizes). The client will replace this software with the new Leve system in the next financial year but requires advice on amending its control systems ready for this upgrade.

Requirement

Discuss the impact on the audit approach for Bee5 from the above information. Make specific reference to any quality management issues that will affect the audit.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

Where IFRS allows a choice of accounting policy, directors may wish to select the policy that gives the most favourable picture, rather than the one which is most useful to users of financial statements. For example, they may wish to adopt the direct, rather than the indirect, method of preparing a statement of cash flows if they believe that gives a more favourable view of the company's liquidity and solvency in the eyes of a lender, such as a bank. Auditors need to be on the lookout for this kind of manipulation.

Answer to Interactive question 2

Several quality management issues are raised in the scenario.

Engagement partner

An engagement partner is usually appointed to each audit engagement undertaken by the firm, to take responsibility for the engagement and its quality management on behalf of the firm. Assigning the audit to the experienced audit manager is not sufficient.

The lack of audit engagement partner also means that several of the requirements of ISA 220 (Revised) about ensuring that arrangements in relation to independence and directing, supervising and reviewing the audit are not in place.

Conflicting views

In this scenario the audit manager and senior have conflicting views about the valuation of inventory. This does not appear to have been handled well, with the manager refusing to discuss the issue with the senior.

ISA 220 (Revised) requires that the audit engagement partner takes responsibility for settling disputes in accordance with the firm's policy in respect of resolution of disputes required by ISQM 1. In this case, the lack of engagement partner may have contributed to this failure to resolve the disputes. In any event, at best, the failure to resolve the dispute is a breach of the firm's policy under ISQM 1. At worst, it indicates that the firm does not have a suitable policy concerning such disputes as required by ISQM 1.

Answer to Interactive question 3

3.1 Working papers are necessary for the following reasons:

- To assist the engagement team to plan and perform the audit
- To assist members of the engagement team responsible for supervision to direct and supervise the audit procedures, and to discharge their review responsibilities in accordance with ISA 220 (Revised)
- To enable the engagement team to be accountable for its work
- As a record of matters of continuing significance to future audits
- To enable the conduct of engagement quality reviews and inspections in accordance with ISQM 1
- To enable the conduct of external inspections in accordance with applicable legal, regulatory or other requirements

3.2 Information/reasons

Information	Reasons
(1) **Administration**	
Client name Year end Title	Enables an organised file to be produced
Date prepared	Enables papers to be traced if lost
Initials of preparer	Any questions can be addressed to the appropriate person
	Seniority of preparer is indicated
Initials of senior to indicate review of junior's work	Evidence that guidance on planning, controlling and recording is being followed
	Evidence of adherence to auditing standards
(2) **Planning**	
Summary of different models of TVs and Blu- ray players held and the approximate value of each	Enables auditors to familiarise themselves with different types of inventory lines
Summary of different types of raw material held and method of counting small components	
Summary of different stages of WIP identified by client	
Time and place of count	Audit team will not miss the count
Personnel involved	Auditor aware who to address questions/ problems to
Copy of client's inventory count instructions and an assessment of them	Enables an initial assessment of the likely reliability of Viewco's count Assists in determining the amount of procedures audit team need to do Enables compliance work to be carried out; that is, checking Viewco staff follow the instructions
Plan of warehouse	To ensure all areas covered at count Clear where to find different models/components Location of any third party/moving inventory clear
Details of any known old or slow moving lines	Special attention can be given to these at count; for example, include in test counts
Scope of test counts to be performed that is, number/value of items to be counted and method of selection. For Viewco probably more counting of higher value finished goods	Ensures appropriate amount of procedures performed based on initial assessment Clear plan for audit team

Information	Reasons
(3) **Objectives of attendance**; that is, to ensure that the quantity and quality of inventory to be reflected in the financial statements is materially accurate	Reporting partner can confirm if appropriate/adequate procedures performed
(4) **Details of procedures performed**	Provides evidence for future reference and documents adherence to auditing standards Enables reporting partner to review the adequacy of the procedures and establish whether it meets the stated objective
(a) **Details of controls testing procedures performed** – observing Viewco's counters and ensuring they are following the instructions and conducting the count effectively, for example: • Note of whether the area was systematically tidied • Note of whether or how counted goods are marked	
Enable reassessment of likely reliability of Viewco's count Enables assessment of chances of items being double-counted or omitted	
Note of how Viewco records and segregates any goods still moving on count day	
Note of adequacy of supervision and general impression of counters	Enables assessment of overall standard of count and hence likely accuracy
Note whether counters are in teams of two and whether any check counts are performed	Evidence of independent checks may enhance reliability
(b) **Details of substantive procedures performed**: Details of items of raw materials or finished goods test counted:	
From physical inventory to client's count sheet	Evidence to support the accuracy and completeness of Viewco's count sheets
From Viewco's count sheets to physical inventory	Evidence to support the existence of inventory recorded by Viewco
For both of the above note inventory code, description, number of units and quality. Use a symbol to indicate agreement with Viewco's records	
Details of review for any old/obsolete inventory, for example dusty/damaged boxes. Note code, description, number of units and problem	Details can be followed up at final audit and the net realisable value investigated

Information	Reasons
Details of review of WIP	
Assessment of volume of part complete items of each stage Assessment of appropriateness of degree of completion assigned to each stage by Viewco (could describe items at various stages)	Evidence in support of accuracy of quantity of WIP Details can be followed through at final audit to final inventory sheets Basis for discussion of any description
Copies of: • Last few despatch notes • Last few goods received notes • Last few material requisitions • Last few receipts to finished goods	Enables follow up at final audit to ensure cut- off is correct; that is, goods despatched are reflected as sales, goods received as purchases and items in WIP are not also in raw materials and finished goods
Copies of client's inventory count sheets (where number makes this practical)	Enables follow up at final audit to ensure that Viewco's final sheets are intact and no alterations have occurred
(5) **Summary of results** In particular: • Details of any problems encountered • Details of any test count discrepancies and notes of investigation into their causes • Details of any representations by the management of Viewco	Senior/manager can assess any consequences for audit risk and strategy and decide any further procedures needed Provides full documentation of issues that could require a judgemental decision and could ultimately be the basis for a qualified opinion
(6) **Conclusion** The auditor will state their overall audit conclusions from the procedures completed.	Indicates whether or not the initial objective has been met and whether there are any implications for the audit opinion

Answer to Interactive question 4

Explanation as follows:

- Has the work been **performed** in **accordance with the audit programme**?

  The non-current asset procedure of agreeing non-current asset details from the asset register to the actual asset is to confirm the existence of the asset – in other words, that the asset should be included in the register. Agreeing physical asset details back to the register tests for the assertion of completeness, not existence; that is, all assets that should be recorded in the register are recorded – not that assets in the register do exist. The audit procedure has therefore not been completed in accordance with the audit programme.

  I recommend that the existence test is completed as specified. However, where physical existence of the asset cannot be determined by seeing the asset, then alternative evidence such as the log book is obtained.

- Have the work performed and the results obtained been **adequately documented**?

Adequate documentation normally means that written representations by management are recorded in writing, either in a paper document or through use of email or other electronic communication system that can be traced back to the client. Regarding the completeness of non- current assets, it is unclear how the representation from the director was received – although it appears that this was only verbal. The difficulty with verbal evidence is that it can be disputed at a later date.

I recommend that the director's representation is obtained in writing.

- Have any **significant matters** been **resolved** or are reflected in audit conclusions?

  The fact that some vehicles were found obviously not in working order is cause for concern. While your primary task was satisfying the assertions of existence and completeness, where assets are obviously unusable, this fact needs to be recorded. The issue is that assets may well be overvalued in the financial statements; in practice the asset values need to be compared to the carrying amounts in the asset register and, where the asset will no longer be used, complete write-off or disposal considered.

  While no further action may be necessary on completeness and existence, I recommend that you prepare a list of the assets which are in a poor state of repair so additional valuation procedures can be performed on them.

- Have the **objectives** of the audit procedures been achieved?

  As already noted, the objectives of audit procedures have not been achieved. There is still insufficient evidence to confirm the existence and completeness of non-current assets.

  I recommend that the procedures you were carrying out are completed as detailed in the audit programme.

- Are the **conclusions** expressed **consistent** with the results of the work performed and do they support the audit opinion?

  The conclusion on the assertions of completeness and existence is incorrect. Your memo states that assets were correctly stated and valued.

  The point is not valid for two reasons.

  First, audit procedures have not been completed correctly (see the point on completeness testing for example) which means that the assertion of completeness cannot be confirmed.

  Second, the audit procedures carried out do not relate to the valuation of those assets. Valuation procedures include the auditing of depreciation and not simply ascertaining the condition of those assets at the end of the reporting period.

  I recommend that when audit procedures are complete that the conclusion is amended to match the assertions being audited.

Answers to Self-test questions

1 Performance and position

Performance

The financial performance of a company comprises the return it obtains on the resources it controls. Performance can be measured in terms of the profits and comprehensive income of the company and its ability to generate cash flows.

Management will be assessed on their skill in achieving the highest level of performance, given the resources available to them.

Information on performance can be found in:

- the statement of profit or loss and other comprehensive income;
- the statement of changes in equity; and
- the statement of cash flows.

Position

The financial position of the company is evaluated by reference to:

- its economic resources and claims;
- its capital structure ie, its level of debt finance and shareholders' funds; and
- its liquidity and solvency.

The user of the financial statements can then make assessments on the level of risk, ability to generate cash, the likely distribution of this cash and the ability of the company to adapt to changing circumstances.

The statement of financial position is the prime source of information on a company's position but the statement of cash flows will also indicate a company's cash position over a period of time.

2 LaFa plc

Culture of WTR

The quality management standard, ISQM 1, requires that the firm implements policies and procedures such that the internal culture of the firm is one where quality is considered essential. Such a culture must be inspired by the leaders of the firm, who must sell this culture in their actions and messages. In other words, the entire business strategy of the audit firm should be driven by the need for quality in its operations.

In the WTR audit firm, there appears to be a lack of leadership on quality management leading to the risk that the firm's quality objectives may not be achieved. Two issues give rise for concern:

(1) First, the partner responsible for quality management resigned during the audit of LaFa plc and has not been replaced. This means that there is no one person in charge of maintaining quality standards within the audit firm. There is the risk that deficiencies of quality management will go undetected. It is also unclear whether the senior leadership team of the firm has taken any responsibility for quality as required by ISQM 1 para. 20.

(2) Second, WTR is under fee pressure from LaFa plc to complete the audit and provide other services for the same fee as last year, even though the scope of the audit has increased.

There is the risk that audit procedures will not be fully carried out to ensure that the tight budget is met. Lack of a comprehensive engagement quality review (exacerbated by the quality management partner resigning as noted above) increases the risk of poor quality work.

The quality management partner should be replaced as soon as possible and in the interim, the senior leadership team of the firm must take temporary responsibility for quality, while the fee situation with LaFa should be monitored – any potential cost overrun must be discussed with the client and where necessary additional fees agreed.

Ethical requirements

Policies and procedures should be designed to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements.

In WTR, it is not clear that staff will comply with the code. While professional staff will be members of ICAB or a similar body, and therefore subject to the ethical requirements of their professional body, precise implementation has not been confirmed within WTR. While it is unlikely that staff will knowingly break the ethical code, there is still room for inadvertent breaches. For example, partners may not be aware of the full client list of WTR and hold shares in an audit client. Similarly, audit staff may not be aware of WTR's policy on entertainment and therefore accept meals, for example, over these guidelines.

The guidelines should be circulated and confirmed by all staff as soon as possible.

Client acceptance

A firm should only accept, or continue with, a client where it:

- has considered the integrity of the client and does not have information that the client lacks integrity;
- is competent to perform the engagement and has the necessary time and resources; and
- can comply with ethical requirements including appropriate independence from the client.

While there is little indication that LaFa lacks integrity, the client is placing fee pressure on WTR. The client has also indicated that information regarding development expenditure may not be available during the audit and will be subject to a separate audit check just before the signing of the financial statements and auditor's report. There could be an attempt to 'force' an unmodified auditor's report when WTR should take more time (and money) auditing development expenditure. There is therefore a risk that LaFa management is losing some integrity and WTR need to view other management evidence with increased scepticism.

The audit of LaFa plc this year includes development expenditure. As this is a new audit area, the audit partner of LaFa should have ensured that the audit team, and WTR as a whole, had staff with the necessary experience to audit this item. Lack of competence increases audit risk, as the area may not be audited correctly or completely.

Mr W accepting the position of Finance Director at SoTee appears to place the independence of WTR with LaFa in jeopardy. As Finance Director of the parent company, Mr W will be in a position to influence the management of LaFa, and potentially the financial information being provided by that company. While SoTee is not an audit client, the audit partner in WTR must ensure that no undue influence is being placed on LaFa. If, however, this is the case, then WTR must consider resignation from the audit of LaFa.

Monitoring of audit

The audit firm must have policies in place to ensure that quality management policies and procedures are implemented and maintained.

Regarding the audit of LaFa, there is some risk that quality standards regarding audit monitoring will be compromised because:

- the audit partner is new, and may therefore not have extensive knowledge of the audit client; and
- there appears to be a tight audit deadline for auditing development expenditure.

To decrease audit risk, it will be appropriate to maintain similar audit staff from last year (eg, retain the audit senior and manager) and WTR could consider an engagement quality review using ISQM 2 to ensure WTR quality management standards have been followed.

3 Bee5

Client acceptance

In previous years Bee5 has required a standard audit from your assurance firm. However, this year there is a request for additional assurance regarding the internal control systems. This work will not only raise the amount of income generated from the client but will also require the use of specialist staff to perform the work.

Before accepting the engagement for this year Sheridan & Co must ensure the following:

(1) That income from Bee5 is not approaching 15% of the firm's total income. If income is approaching this level then additional independence checks may be required, such as an engagement quality review.

(2) That staff familiar with the Bee5 internal control system are available to provide the assurance work. If these skills are not available then Sheridan & Co must either hire staff with those skills or decline the work on internal control systems. Sheridan & Co must also ensure that they will not be taking responsibility for designing, implementing or maintaining internal control as under the Ethical Standard this would be a management decision-making activity.

Plan the audit – evaluate internal control

The current internal control system is due to be upgraded in the next financial year. There is therefore no impact on the current year's audit as a result of this change. However, the reason given by the client for the upgrade relates to reliability issues with the current control systems.

The control system used by Bee5 must still be evaluated to determine the extent to which the system is still reliable. Where deficiencies are identified then control risk will increase. There will be consequent impact on the audit approach as noted below.

Develop the audit approach

An increase in control risk will cause detection risk to increase. The impact on the audit will be an increased level of substantive testing to obtain sufficient confidence on assertions such as completeness and accuracy.

There will be a further impact on the quality management of the audit. Commencing the audit with the expectation of finding control deficiencies means that audit staff must be selected carefully. It may not be appropriate to send junior trainees with restricted experience to the client unless their work is closely monitored and carefully reviewed.

Audit internal control – tests of controls

As noted above, detailed tests of control on the accounting system will be limited. However, reliance will still be obtained from the overall control environment.

Evaluate results

The higher risk associated with the audit this year means that an engagement quality review will be appropriate for this client. Sheridan & Co needs to maintain the integrity of work performed as well as ensuring that the proposed audit opinion is appropriate. Part of the planning process will be to book the time of the quality management partner.

Chapter 2

Principles of corporate reporting

Introduction

Learning outcomes

- Explain and appraise the impact of accounting principles and bases of measurement in corporate reporting, for example fair value measurement
- Appraise corporate reporting regulations, and related legal requirements, with respect to presentation, disclosure, recognition and measurement
- Explain and appraise accounting standards that relate to the impact of changes in accounting policies and estimates
- Explain and evaluate the impact of underlying assumptions on financial statements
- Identify and explain current and emerging issues in corporate reporting
- Formulate and evaluate accounting and reporting policies for single entities and groups of varying sizes and in a variety of industries
- Explain and evaluate how different methods of recognising and measuring assets and liabilities can affect reported financial position and explain the role of data analytics in financial asset and liability valuation
- Explain and evaluate corporate reporting and assurance issues in respect of social responsibility, sustainability and environmental matters for a range of stakeholders
- Evaluate accounting policies choices and estimates, identifying issues of earnings manipulation and creative accounting

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
1	**The regulatory framework** This short section revises the regulatory framework and the standard-setting process.	**Approach** Read through quickly – this should be familiar to you from your earlier studies. **Stop and think** The process of setting IFRS® Standards is an open dialogue involving co- operation between national and international standard setters.	You are unlikely to be tested directly on this material – it is background knowledge.	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
2	**The IASB *Conceptual Framework*** Before launching into the detail of financial reporting and auditing standards, it is important to understand the principles that underpin them.	**Approach** *Conceptual Framework* forms the basis of the approach followed in developing IFRS® Standards. It can also be used to establish the accounting treatment where there is no IFRS on the subject. Study in detail – this version of the *Conceptual Framework* was revised in 2018 and may be different from the one you studied earlier. **Stop and think** Can you think of any advantages and disadvantages of a conceptual framework?	You may encounter a scenario where no IFRS is directly applicable or there is no obvious answer. Application of the *Conceptual Framework* will assist you in determining the appropriate financial reporting treatment by going back to first principles.	**IQ1: Asset or liability?** It is essential you do this short question in which you must **apply** the *Conceptual Framework* definition of asset and liability.
4	**IFRS 13, *Fair Value Measurement*** IFRS 13, *Fair Value Measurement* (section 4) brings together guidance on fair value and requires disclosures. It defines fair value as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date'. IFRS 13 will crop up throughout the manual in all kinds of contexts.	**Approach** Work through this section as if learning the IFRS from scratch. This is essential, as it comes up regularly in the manual and in the exam. **Stop and think** Why is fair value not adjusted for transaction costs?	If you look at the table in Section 4.5.2, you will see a range of contexts in which fair value could come up in the exam: Share valuation Intangible assets Impairment PPE Financial instruments	N/A

CHAPTER 2

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
5	***IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors*** This material should be familiar from your earlier studies.	**Approach** Treat this as revision. The key points are that changes in accounting policies are rare, and allowed only if required by statute/standard-setting body/results in reliable and more relevant information. Changes in accounting estimates are more common because of the judgement required in making estimates. **Stop and think** Why are changes in accounting estimates not accounted for by retrospective application?	IAS 8 could come up in any context, particularly where the directors are trying to change the accounting policy to give a more favourable view. This also raises ethical issues.	**IQ2: Accounting errors** Revision question on correction of a prior period error.
6	**Current issues in corporate reporting** This section summarises the key current issues and points to where they are treated in more detail. The most important current issues are the revised *Conceptual Framework*, covered in Section 2 and sustainability, covered in Section 6.	**Approach** Current issues are covered in this Workbook within the chapters in which the topic appears, so that the changes/proposed changes appear in context. **Stop and think** Which recent document deals with a concept also dealt with in the revised *Conceptual Framework?*	While exams test IFRS that are already in force (Blue Book), if published revised IFRS is not yet examinable, part of a question may ask for a brief explanation as to how the accounting treatment may change.	N/A

1 The regulatory framework

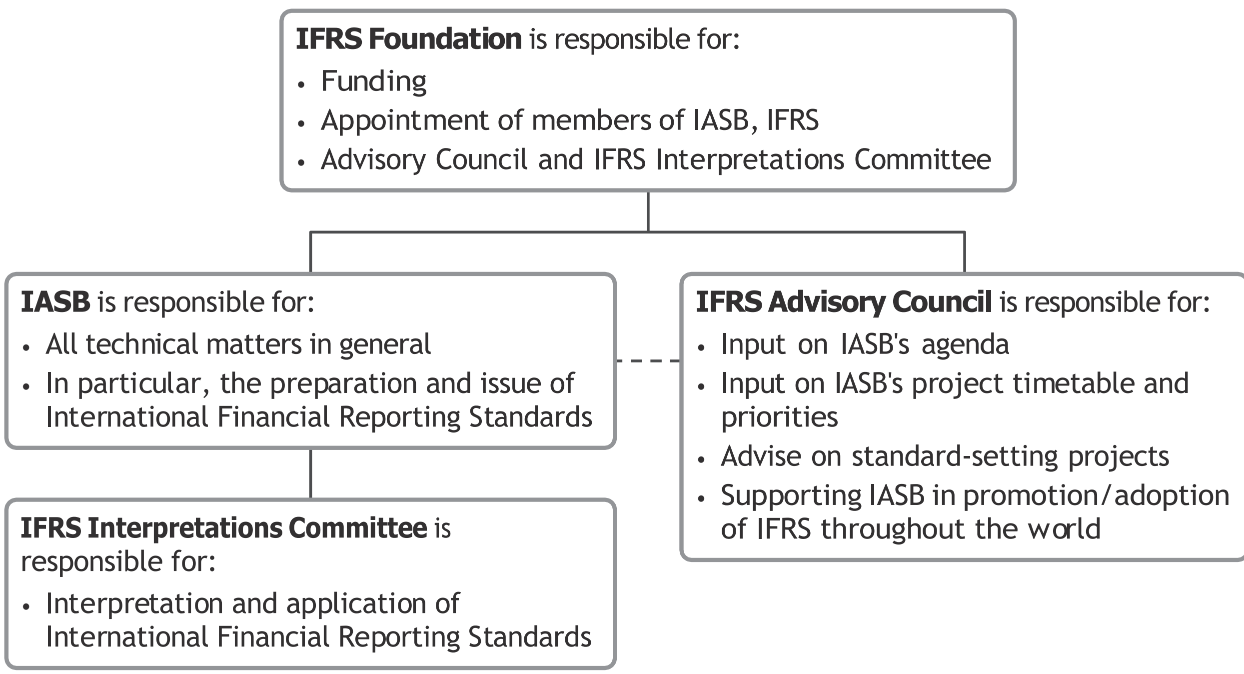
Section overview

- Financial reporting is the provision of financial information to those outside the entity.
- The organisation responsible for setting IFRS® Standards comprises the International Financial Reporting Standards Foundation (IFRS Foundation), the Monitoring Board, the International Accounting Standards Board (IASB), the IFRS Advisory Council (Advisory Council) and the IFRS Interpretations Committee (Interpretations Committee).
- The process of setting IFRS is an open dialogue involving co-operation between national and international standard setters.

1.1 The IFRS Foundation

IASCF was formed in 2001 as a not-for-profit corporation and was the parent entity of the **IASB**. In 2010 it was renamed as the **IFRS Foundation**. The IFRS Foundation is an independent organisation and its trustees **exercise oversight** and raise necessary **funding** for the IASB to carry out its role as standard setter. It also oversees the work of the IFRS Interpretations Committee (formerly called the **International Financial Reporting Interpretations Committee** (IFRIC)) and the IFRS Advisory Council (formerly called the **Standards Advisory Council** (SAC)). These are organised as follows:

Figure 2.1: IFRS Foundation



IFRS Foundation is responsible for:

- Funding
- Appointment of members of IASB, IFRS
- Advisory Council and IFRS Interpretations Committee

IASB is responsible for:

- All technical matters in general
- In particular, the preparation and issue of International Financial Reporting Standards

IFRS Interpretations Committee is responsible for:

- Interpretation and application of International Financial Reporting Standards

IFRS Advisory Council is responsible for:

- Input on IASB's agenda
- Input on IASB's project timetable and priorities
- Advise on standard-setting projects
- Supporting IASB in promotion/adoption of IFRS throughout the world

1.2 Membership

Membership of the IFRS Foundation has been designed so that it represents an international group of preparers and users, who become IFRS Foundation trustees. The selection process of the **22 trustees** takes into account geographical factors and professional background. IFRS Foundation trustees **appoint the IASB members**.

The **Monitoring Board** ensures that the trustees carry out their duties in accordance with the IFRS Foundation Constitution.

1.3 The IASB

The IASB is responsible for setting accounting standards. It is made up of 15 full-time members and has no particular geographical dominance.
Members have a variety of backgrounds and include the following:

- Auditors
- Preparers of financial statements
- Users of financial statements
- Academics

1.4 Objectives of the IASB

The *Preface to IFRS Standards* states that the objectives of the IASB are as follows:

(a) To develop, in the public interest, **a single set of high quality, understandable, enforceable and globally accepted financial reporting standards** based on clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the various capital markets of the world and other users of the information to make economic decisions.

(b) To promote the **use and rigorous application** of those standards.

(c) In fulfilling the above objectives to take account of, as appropriate, the needs of a range of sizes and types of entities in diverse economic settings.

(d) To promote and facilitate the adoption of IFRS Standards through the **convergence** of national accounting standards and IFRS Standards.

1.5 The purpose of accounting standards

The overall purpose of accounting standards is to identify **proper accounting practices** for the preparation of financial statements.

Accounting standards create a **common understanding** between users and preparers on how particular items, for example the valuation of property, are treated. Financial statements should therefore comply with all applicable accounting standards.

1.6 Application of IFRS

Within each individual country **local regulations govern**, to a greater or lesser degree, the issue of financial statements. These local regulations include accounting standards issued by the national regulatory bodies or professional accountancy bodies in the country concerned.

Over the last 25 years, however, the **influence of IFRS on national accounting requirements and practices has been growing**. For example: Since 2005, all EU companies whose securities are traded on a regulated public market such as the London Stock Exchange **must prepare their consolidated accounts in accordance with IFRS**. (Note that although **group** financial statements must follow IFRS the **individual** financial statements do not need to.)

1.7 Setting of IFRS

The overall agenda of the IASB is initially set by discussion with the IFRS Advisory Council. The process for developing an individual standard involves the following steps.

Chapter 1: The objective of general purpose financial reporting

Chapter 2: Qualitative characteristics of useful financial information

Chapter 3: Financial statements and the reporting entity

Chapter 4: The elements of financial statements

Chapter 5: Recognition and derecognition

Chapter 6: Measurement

Chapter 7: Presentation and disclosure

Chapter 8: Concepts of capital and capital maintenance

During the early stages of a project, the IASB may establish an **Advisory Committee or working group** to give advice on issues arising in the project. Consultation with the Advisory Committee and the Advisory Council occurs throughout the project.

The IASB may develop and publish a **Discussion Paper** for public comment.

Following the receipt and review of comments, the IASB would develop and publish an **Exposure Draft** for public comment.

Following the receipt and review of comments, the IASB would issue a final **International Financial Reporting Standard**.

The period of exposure for public comment is normally 120 days. However, in some circumstances, proposals may be issued with a comment period of not less than 30 days. Draft IFRS Interpretations are exposed for a 60-day comment period.

1.8 Scope and authority of IFRS

The *Preface to IFRS Standards* makes the following points:

(a) IFRS Standards apply to **all general purpose financial statements** ie, those directed towards the common information needs of a wide range of users.

(b) The IASB's objective is to **require like transactions and events to be accounted for and reported in a like way. The IASB intends not to permit choices in accounting treatment.** The IASB is reconsidering those transactions and events for which IFRS Standards permit a choice of accounting treatment with the objective of reducing the number of those choices.

(c) Standards include paragraphs in bold and plain type. **Bold type paragraphs** indicate the **main principles**, but **both types have equal authority.**

(d) Any limitation of the applicability of a specific IFRS is made clear in that standard.

2 The IASB *Conceptual Framework*

Section overview

The *Conceptual Framework for Financial Reporting* determines:

- how financial statements are prepared; and
- the information they contain.

2.1 *Conceptual Framework*

A conceptual framework is a statement of generally accepted theoretical principles which form the frame of reference for financial reporting.

These theoretical principles provide the basis for the IASB's development of new accounting standards and the evaluation of those already in existence. The financial reporting process is concerned with providing information that is useful in the business and economic decision-making process. Therefore a conceptual framework will form the theoretical basis for determining which events should be accounted for, how they should be measured and how they should be communicated to the user. Although it is theoretical in nature, a conceptual framework for financial reporting has highly practical final aims.

The *Conceptual Framework* consists of eight chapters.

Chapter 1: The objective of general purpose financial reporting

Chapter 2: Qualitative characteristics of useful financial information

Chapter 3: Financial statements and the reporting entity

Chapter 4: The elements of financial statements

Chapter 5: Recognition and derecognition

Chapter 6: Measurement

Chapter 7: Presentation and disclosure

Chapter 8: Concepts of capital and capital maintenance

2.2 Purpose and status

The purpose of the *Conceptual Framework* is to (para. SP1.1):

- Assist the IASB to develop IFRS Standards that are based on consistent concepts;
- Assist preparers of accounts to develop accounting policies in cases where there is no IFRS applicable to a particular transaction, or where a choice of accounting policy exists; and
- Assist all parties to understand and interpret IFRS Standards.

The instances in which a preparer will use the Conceptual Framework to develop an accounting policy are expected to be **rare.** Therefore the Conceptual Framework will primarily be used by the IASB to develop IFRS Standards.

The *Conceptual Framework* is not a Standard. It **does not override any IFRS**, but instead forms the conceptual basis for the development of IFRS Standards.

However, IAS 1, *Presentation of Financial Statements* states that in order to achieve fair presentation, an entity must comply with both:

- IFRS; and
- The *Conceptual Framework for Financial Reporting*.

Many of the IASB's standards have been strongly influenced by the ideas set out in the *Conceptual Framework*.

Professional skills focus: Assimilating and using information

When considering the appropriate financial reporting treatment, it is important to consider all the information in order to determine which IFRS to apply. In the absence of an applicable IFRS, the *Conceptual Framework* will assist.

2.3 Chapter 1: The objective of general purpose financial reporting

The *Conceptual Framework* states (para. 1.2) that:

"The objective of general purpose financial reporting is to provide information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity."

- The types of economic decisions for which financial statements are likely to be used include the following.
- Buying, selling or holding equity and debt instruments;
- Providing or settling loans and other forms of credit; or
- Exercising rights to vote on, or otherwise influence, management's actions that affect the use of the entity's economic resources (*Conceptual Framework,* para.1.2)

Existing and potential investors, lenders and other creditors are referred to as the '**primary users**' of financial statements (para. 1.5). These users need information about (para 1.5):

- The **economic resources of the entity**;
- The **claims against the entity**; and
- How efficiently and effectively the entity's management have discharged their responsibilities relating to the entity's resources (**stewardship**)

Three aspects are relevant to users of financial statements (paras. 1.17–1.21):

- Financial performance reflected by accrual accounting
- Financial performance reflected by past cash flows
- Changes in economic resources and claims not resulting from financial performance, eg a share issue

The *Conceptual Framework* makes it clear that this information should be prepared on an **accruals basis**.

Definition

Accrual accounting: The effects of transactions and other events and circumstances on a reporting entity's economic resources and claims are recognised in the periods in which they occur, even if the resulting cash receipts and payments occur in a different period. (*Conceptual Framework*: para 1.17)

Financial statements prepared using accrual accounting (the accruals basis) show users' past transactions.

Information about a reporting entity's cash flows during a period also helps users assess the entity's ability to generate future net cash inflows and gives users a better understanding of its operations.

The *Conceptual Framework* also mentions several other, secondary, users that are interested in the financial information (*Conceptual Framework,* Chapter 1: para. 1.9, 1.10).

This includes:

- Management
- Regulators
- Members of the public

While users may gain most of their information from the financial statements, it is important that they obtain relevant information from other sources too.

2.4 Chapter 2: Qualitative characteristics of useful financial information

2.4.1 Overview

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users.

The two **fundamental qualitative characteristics** are **relevance** and **faithful representation**.

There are then four **enhancing qualitative characteristics** which enhance the usefulness of information that is relevant and faithfully represented. These are: **comparability, verifiability, timeliness** and **understandability**.

The key issues can be summarised as follows.

Fundamental qualitative characteristics

Relevance

Relevant financial information is capable of making difference in the decisions made by users (*Conceptual Framework*, paras. 2.6 – 2.7), ie if it has:

- Predictive value; and/or
- Confirmatory value.

Materiality

Information is material if omitting, misstating or obscuring it could influence decisions that the primary users of general purpose financial statements make on the basis of financial information (*Conceptual Framework*, para. 2.11)

Faithful representation

To be useful, financial information must not only represent the relevant phenomena but must also faithfully represent the substance of the phenomena that it purports to represent (*Conceptual Framework*, para. 2.12).

A perfect faithful representation would be:

- Complete;
- Neutral; and
- Free from error.

Prudence

Prudence is exercising caution, particularly with areas where judgement or estimation is required. Supports the concept of neutrality.

Enhancing qualitative characteristics

Comparability

Information is more useful if it can be compared with similar information about:

- Other entities; and
- Other periods.

Consistency helps achieve comparability.

Verifiability

Assures users that information faithfully represents the economic phenomenon it purports to represent (*Conceptual Framework*, para. 2.30)

Verification can be direct or indirect.

Timeliness

Having information available to decision makers in time to be capable of influencing their decisions (*Conceptual Framework*, para. 2.33)

Balance between timeliness and accuracy of information.

Understandability

Classifying, characterising and presenting information clearly and concisely (*Conceptual Framework*, para. 2.34).

The cost constraint on useful financial reporting

Consideration of whether the benefits of reporting particular information justify the costs incurred to provide and use that information.

CHAPTER 2

2.5 Chapter 3: Financial statements and the reporting entity

2.5.1 Overview

Chapter 3 of the *Conceptual Framework* covers the objectives and scope of the financial statements, including the definition of the reporting period and the main perspective adopted in the financial statements: the financial statements should provide information about transactions from the perspective of the reporting entity, not that of the investors. This is to try to avoid investor bias when reporting on the entity.

2.5.2 Objective and scope of financial reporting

The objective of financial statements is to provide financial information about the reporting entity's assets, liabilities, equity, income and expenses that is useful to users of financial statements in assessing the prospects for future net cash inflows to the reporting entity and in assessing management's stewardship of the entity's economic resources. (*Conceptual Framework,* Chapter 3: para. 3.2).

2.5.3 Reporting period

Financial statements are prepared for a specific period of time (the reporting period) and provide information about assets and liabilities, and income and expenses. Comparative information must also be provided.

The financial statements should provide information about transactions from the perspective of the reporting entity, not that of the investors. This is to try to avoid investor bias when reporting on the entity.

(*Conceptual Framework,* Chapter 3: para. 3.4, 3.5).

2.5.4 Underlying assumption: going concern

Definition

Going concern: Financial statements are normally prepared on the assumption that the reporting entity is a going concern, and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the necessity of liquidation nor the need to cease trading.

(*Conceptual Framework*: para. 3.9)

It is assumed that the entity has no intention to liquidate or curtail major operations. If it did, then the financial statements would be prepared on a **different (disclosed) basis** for example, the 'break up' basis.

2.5.5 The reporting entity

Definition

Reporting entity: An entity that is required, or chooses, to prepare financial statements. A reporting entity can be a single entity or a portion of an entity or can comprise more than one entity. A reporting entity is not necessarily a legal entity (para. 3.10).

2.5.6 Consolidated and unconsolidated financial statements

If a reporting entity comprises both the parent and its subsidiaries, the reporting entity's financial statements are referred to as 'consolidated financial statements'. If a reporting entity is the parent alone, the reporting entity's financial statements are referred to as 'unconsolidated financial statements').

(*Conceptual Framework,* Chapter 3: para. 3.15 – 3.17).

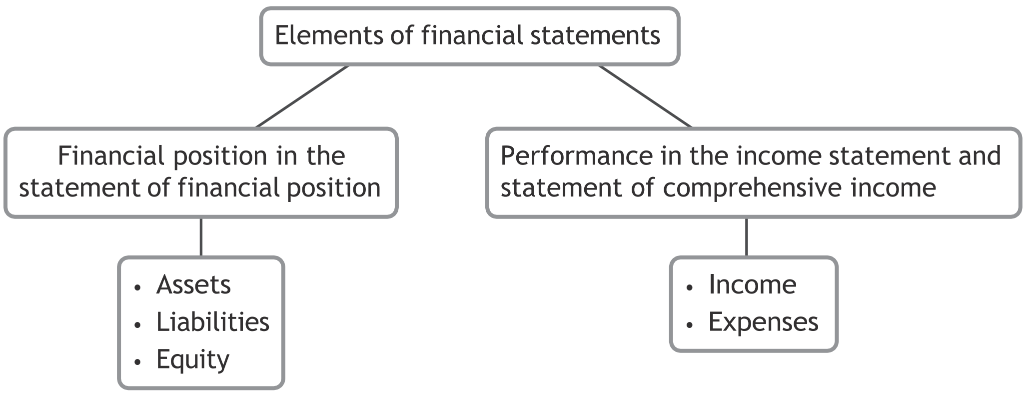
2.6 Chapter 4: The elements of financial statements

2.6.1 Overview

Transactions and other events are grouped together in broad **classes** and in this way their financial effects are shown in the financial statements. These broad classes are the elements of financial statements.

The *Conceptual Framework* lays out these elements as follows.

Figure 2.2: Elements of financial statements



Contributions from equity participants and distributions to them are shown in the statement of changes in equity.

2.6.2 Definitions of elements

Element	Definition	Comment
Asset	A present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits.	Technically, the asset is the potential to produce economic benefits (eg, cash generation), not the underlying item of property itself (eg, a machine).
Liability	A present obligation of the entity to transfer an economic resource as a result of past events.	An essential characteristic of a liability is that the entity has an obligation. An obligation is 'a duty or responsibility that the entity has no practical ability to avoid'
Equity	The residual amount found by deducting all the entity's liabilities from all the entity's assets.	Equity = ownership interest = net assets. For a company, this usually comprises shareholders' funds (ie, capital and reserves).
Income	Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from equity participants.	Income comprises revenue and gains, including all recognised gains on non-revenue items (eg, revaluations of non-current assets).
Expenses	Decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to equity participants.	Expenses include losses, including all recognised losses on non-revenue items (such as write downs of non- current assets).

Note the way that the changes in economic benefits resulting from asset and liability increases and decreases are used to define:

- Income
- Expenses

This arises from the '**balance sheet approach**' adopted by the *Conceptual Framework* which treats performance statements, such as the statement of profit or loss and other comprehensive income, as a means of reconciling changes in the financial position amounts shown in the statement of financial position.

IFRS 16, *Leases* requires a lessee to recognise a right-of-use asset for each lease they enter into (with limited exceptions). A right-of-use asset is consistent with the definition of an asset in the *Conceptual Framework:* as a result of entering into the lease agreement (past event), the lessee can direct the use of the leased asset (control) in the course of business in order to directly or indirectly generate economic benefits.

IFRS 16 also requires the recognition of a lease liability, equivalent to the present value of future lease payments. The lease liability meets the *Conceptual Framework* definition of a liability: the lessee has a responsibility (present obligation) as a result of entering into the lease agreement (past event) to pay the lease rentals (transfer of economic benefits) as they become due.

These key definitions of 'asset' and 'liability' will be referred to again and again in these learning materials, because they form the foundation on which so many accounting standards are based. It is very important that you can reproduce these definitions accurately and quickly.

2.6.3 Assets

We can look in more detail at the components of the definitions given above.

Assets must give rise to **future economic benefits**, either alone or in conjunction with other items.

Definition

Potential to produce economic benefit: An economic resource is a right that has the potential to produce economic benefits. *(Conceptual Framework,* para.4.14)

In simple terms, an item is an asset if:

- it is **cash** or the **right to cash** in future eg, a receivable, or a **right to services** that may be used to generate cash eg, a prepayment; or
- it can be used to **generate cash** or **meet liabilities** eg, a tangible or intangible non-current asset.

The **existence** of an asset, particularly in terms of **control**, is **not reliant** on:

- **physical form** (hence intangible assets such as patents and copyrights may meet the definition of an asset and appear in the statement of financial position – even though they have no physical substance); or
- **legal ownership** (hence some leased assets, even though not legally owned by the company, may be included as assets in the statement of financial position (see Chapter 14).

Transactions or events in the **past** give rise to assets. Those expected to occur in future do not in themselves give rise to assets.

2.6.4 Liabilities

Again we look more closely at some aspects of the definition.

For a liability to exist, three criteria must all be satisfied (para. 4.27):

- The entity has an obligation
- The obligation is to transfer an economic resource
- The obligation is a present obligation that exists as a result of past events

Definition

Obligation: A duty or responsibility that the entity has no practical ability to avoid (para.4.29)

A present obligation exists as a result of past events if the entity has already obtained economic benefits or taken an action, and as a consequence, the entity will or may have to transfer an economic resource that it would not otherwise have had to transfer (para.4.43)

As seen above, obligations may be:

(a) **legally enforceable** as a consequence of a binding contract or statutory requirement. This is normally the case with amounts payable for goods and services received; or

(b) the result of **business practice**. For example, even though a company has no legal obligation to do so, it may have a policy of rectifying faults in its products even after the warranty period has expired.

A **management decision** (to acquire an asset, for example) **does not in itself create an obligation**, because it can be reversed. But a management decision implemented in a way which creates expectations in the minds of customers, suppliers or employees becomes an obligation. This is sometimes described as a **constructive obligation**. This issue is covered more fully in Chapter 13 in the context of the recognition of provisions.

Liabilities must arise from **past transactions or events**. For example, the sale of goods is the past transaction which allows the recognition of repair warranty provisions.

Settlement of a present obligation will involve the entity **giving up resources** giving rise to economic benefits in order to satisfy the claim of the other party. In practice, most liabilities will be met in **cash** but this is not essential.

Interactive question 1: Asset or liability?

Question	Answer
Oak plc has purchased a patent for £40,000. The patent gives the company sole use of a particular manufacturing process which will save £6,000 a year for the next five years.	
Elm plc paid John Brown £20,000 to set up a car repair shop, on condition that priority treatment is given to cars from the company's fleet.	
Sycamore plc provides a warranty with every washing machine sold.	

See **Answer** at the end of this chapter.

2.6.5 Equity

Equity is the **residual of assets less liabilities**, so the amount at which it is shown is dependent on the measurement of assets and liabilities. It has nothing to do with the market value of the entity's shares.

Equity may be **sub-classified** in the statement of financial position providing information which is relevant to the decision-making needs of the users. This will indicate legal or other restrictions on the ability of the entity to distribute or otherwise apply its equity.

In practical terms, the important distinction between liabilities and equity is that creditors have the **right** to insist that the transfer of economic resources is made to them regardless of the entity's financial position, but owners do not. All decisions about payments to owners (such as dividends or share capital buyback) are at the discretion of management.

2.6.6 Performance

Profit is used as a **measure of performance**, or as a basis for other measures (eg, earnings per share (EPS)). It depends directly on the measurement of **income and expenses**, which in turn depend (in part) on the concepts of capital and capital maintenance adopted.

Income and expenses can be **presented in different ways** in the statement of profit or loss and other comprehensive income, to provide information relevant for economic decision-making. For example, a statement of profit or loss and other comprehensive income could distinguish between income and expenses which relate to continuing operations and those which do not.

Items of income and expense can be **distinguished** from each other or **combined** with each other.

Income

Both **revenue** and **gains** are included in the definition of income. **Revenue** arises in the course of ordinary activities of an entity. (We will look at revenue in more detail in Chapter 10.)

Definition

Gains: Increases in economic benefits. As such, they are no different in nature from revenue.

Gains include those arising on the disposal of non-current assets. The definition of income also includes **unrealised gains** eg, on **revaluation** of non-current assets.

A **revaluation** gives rise to an increase or decrease in equity.

These increases and decreases appear in the statement of profit or loss and other comprehensive income.

(Gains on revaluation, which are recognised in a revaluation surplus, are covered in Chapter 12.)

Expenses

As with income, the definition of expenses includes **losses** as well as those expenses that arise in the course of ordinary activities of an entity.

Definition

Losses: Decreases in economic benefits. As such, they are no different in nature from other expenses.

Losses will include those arising on the disposal of non-current assets. The definition of expenses will also include **unrealised losses**.

2.7 Chapter 5: Recognition and derecognition of the elements of financial statements

2.7.1 Meaning of recognised

An item is recognised when it is included in the statement of financial position or statement of profit or loss and other comprehensive income.

Items which meet the definition of assets or liabilities may still not be recognised in financial statements because they must also meet certain **recognition criteria**.

Definition

Recognition: The process of capturing for inclusion in the statement of financial position or statement(s) of profit or loss and other comprehensive income an item that meets the definition of one of the elements of financial statements – an asset, a liability, equity, income or expenses. (*Conceptual Framework*: para. 5.1)

An asset or liability should be recognised if it will be both:

- **Relevant;** and
- Provide users of the financial st**atements with a faithful representation** of the transactions of that entity

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The *Conceptual Framework* takes, therefore, these fundamental qualitative characteristics along with the definitions of the elements of the financial statements as the key components of recognition.

Even if an item is not recognised, then the preparers of the financial statements should consider whether, in order to meet the faithful representation requirement, there should be a description in the notes to the financial statements.

2.7.2 Derecognition

Definition

Derecognition: The removal of all or part of a recognised asset or liability from an entity's statement of financial position. Derecognition normally occurs when that item no longer meets the definition of an asset or liability. (*Conceptual Framework*: para. 5.26)

The *Conceptual Framework* considers derecognition to be a factor when the following occurs:

(a) Loss of control of or all or part of the recognised asset; or

(b) The entity no longer has an obligation for a liability

This is covered in more detail in the following chapters covering the specific elements, such as recognition and derecognition of financial instruments and non- current tangible assets. The IASB has brought these concepts of recognition and derecognition into the *Conceptual Framework* so that they can be revisited when issuing new standards or revising existing ones.

2.8 Chapter 6: Measurement of the elements of financial statements

2.8.1 Overview

A number of different measurement bases are used in financial statements. They include:

- Historical cost
- Value in use
- Fair value
- Current cost

In the *Conceptual Framework*, the guidelines surrounding the measurement of elements are clarified and given more substance.

Definition

Measurement: Elements recognised in the financial statements are quantified in monetary terms. This requires the selection of a measurement basis. (*Conceptual Framework*: para. 6.1)

This involves the selection of a particular **basis of measurement**. A number of these are used to different degrees and in varying combinations in financial statements. They include the following.

Definitions

Historical cost: The price paid for an asset or for the event which gave rise to the liability. The price will not change.

Current value: The price paid for an asset or the liability value will be updated to reflect any changes since it was acquired or incurred. There are three main bases recognised by the *Conceptual Framework* that make up current value:

Fair value: Price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (IFRS 13, Appendix A)

Value in use: The present value of the cash flows, or other economic benefits, that an entity expects to derive from the use of an asset and its ultimate disposal (*Conceptual Framework*, para.6.17).

Current cost: Current cost, like historical cost, is an entry value: it reflects prices in the market in which the entity would acquire assets or incur the liability.

2.8.2 Historical cost

Historical cost is the most commonly adopted measurement basis, but this is usually combined with other bases, eg inventory is carried at the lower of cost and net realisable value.

Recent standards use the concept of fair value, which is defined by IFRS 13 as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date' (IFRS 13: para. 9).

2.8.3 Current value

Current value accounting reflects the valuation of the assets or liabilities based on conditions and information available at the measurement date. The *Conceptual Framework* discusses the bases of measurement, and the factors to be considered when choosing the appropriate measurement method. The three bases that make up current value are fair value, value in use and current cost.

2.8.4 Fair value

The definition of fair value, as stated in IFRS 13 is 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date' (IFRS 13, Appendix A).

The specifics of fair value in relation to tangible non-current assets (IAS 16), business combinations (IFRS 3), biological assets (IAS 41) and non-current assets held for sale and discontinued operations (IFRS 5) are covered in the relevant chapters.

Fair value is most commonly calculated by taking the open market value. Where there is no active market for the asset or liability, then the following should be used as a basis.

- Estimates of future cash flows
- Time value of money (discounting the future cash flows)

In each case, it will be taking into consideration the uncertainty of the market. Fair value looks at the potential future value of the asset or liability.

2.8.5 Value in use

This is calculated by taking the present value of the cash flows or other benefits that the entity will receive during the lifetime of the asset or liability, and deducting any disposal costs. The value of the asset or liability considers the future cash flows (therefore, it does not include the costs of acquiring the item in the first place).

At first glance this seems similar to the fair value basis, however, value in use considers entity specific factors affecting it, and the fair value basis looks at the market perspective.

Value in use looks at the likely future value of the entity using the asset or liability.

2.8.6 Current cost

Current cost, like historical cost, is an entry value: it reflects prices in the market in which the entity would acquire assets or incur the liability (*Conceptual Framework,* para.6.21). Essentially the replacement cost of an asset or liability.

2.9 Chapter 7: Presentation and disclosure

2.9.1 Overview

Chapter 7 of the *Conceptual Framework* covers the high level principles behind the need for a consensus on presentation and disclosure, not just between periods for the entity, but also across different entities.

2.9.2 Principles of presentation and disclosure

Rather than relying on prescriptive rules regarding presentation and disclosure, the main principles are established which include:

- Classification of assets and liabilities of a similar nature together (whilst keeping dissimilar ones separated), according to their nature, function or method of measurement. This is also to avoid the issue of 'offsetting' whereby items of a dissimilar nature are grouped together, for example an asset and a liability offset to provide a much smaller number in the financial statements.
- Avoiding unnecessary detail which can obscure the important facts
- Equally, avoiding a standardised approach (often referred to as 'boilerplate') but instead giving the entity an opportunity to provide details relevant to the organisation and its business
- Specific details regarding the classification of assets, liabilities, equity, income and expenses

2.9.3 Interaction with IAS 1

Financial statements should **present fairly** the financial position, financial performance and cash flows of an entity. **Compliance with IFRS** is presumed to result in financial statements that achieve a fair presentation. (IAS 1: para. 15)

IAS 1 stipulates that financial statements shall present fairly the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, equity, income and expenses set out in the *Conceptual Framework*.

The following points made by IAS 1 expand on this principle.

(a) **Compliance with IFRS** should be disclosed

(b) **All relevant IFRS** must be followed if compliance with IFRS is disclosed

(c) Use of an **inappropriate accounting treatment** cannot be rectified either by disclosure of accounting policies or notes/explanatory material

IAS 1 states what is required for a fair presentation.

(a) Selection and application of suitable **accounting policies**

(b) **Presentation of information** in a manner which provides relevant, reliable, comparable and understandable information

(c) **Additional disclosures** where required

(IAS 1: para. 17)

Professional skills focus: Applying judgement

Judgement is particularly important in the context of disclosure. A balance has to be struck between providing the necessary information for a full understanding and 'information overload', where the important information gets buried.

2.10 Chapter 8: Concepts of capital and capital maintenance

The final section of the *Conceptual Framework* is devoted to a brief discussion of the different concepts of capital and capital maintenance, pointing out that:

- the choice between them should be made on the basis of the needs of users of financial statements; and
- the IASB has no present intention of prescribing a particular model.

2.10.1 Financial capital and capital maintenance

Definition

Financial capital maintenance: Under a financial concept of capital maintenance, such as invested money and invested purchasing power, capital is synonymous with the net assets or equity of the entity.

The financial concept of capital is adopted by most entities.

This concept measures capital as the **equity in the statement of financial position**. Profit is only earned in an accounting period **if the equity at the end of the period is greater than it was at the start**, having excluded the effects of distributions to or contributions from the owners during the period.

Monetary measure of capital

Financial capital is usually measured in **monetary terms** eg, the pound sterling or the euro. This is the concept applied in historical cost accounting. This measure can be quite stable over short periods of years, but is debased by quite low rates of general inflation over longer periods, such as 20 years. So comparisons between capital now and capital 20 years ago are invalid, because the measurement instrument is not constant.

Constant purchasing power

A variant on the monetary measure of financial capital is the constant purchasing power measure. On this basis, **the opening capital (ie, equity) is uprated by the change in a broadly based price index**, often a retail prices index, over the year. Also, the transactions during the year are uprated by the change in the same index. A profit is only earned if **the capital at the end of the year exceeds these uprated values**. (The value of the uprating is taken to equity, but is not regarded as a profit, merely a 'capital maintenance' adjustment.) So this capital maintenance adjustment can be thought of as an additional expense. Comparisons over a 20-year period will be more valid if the capital 20 years ago is uprated for general inflation over that 20-year period.

However, there is no reason why inflation measured by a retail prices index should be at all close to the inflation experienced by an individual company. The physical capital maintenance concept (see below) seeks to address this.

2.10.2 Physical capital and capital maintenance

Definition

Physical capital maintenance: Under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the entity based on, eg, units of output per day.

This concept looks behind monetary values, to the underlying **physical productive capacity of the entity**. It is based on the approach that an entity is nothing other than a means of producing saleable outputs, so a profit is earned only after that productive capacity has been maintained by a 'capital maintenance' adjustment. (Again, the capital maintenance adjustment is taken to equity and is treated as an additional expense in the statement of profit or loss and other comprehensive income.) Comparisons over 20 years should be more valid than under a monetary approach to capital maintenance.

The difficulties in this approach lie in making the capital maintenance adjustment. It is basically a current cost approach, normal practice being to use industry-specific indices of movements in non- current assets, rather than to go to the expense of annual revaluations by professional valuers. The difficulties lie in finding indices appropriate to the productive capacity of a particular entity.

Context example: Capital maintenance concepts

Meercat plc purchased 20,000 electrical components on 1 January 20X7 for £10 each. They were all sold on 31 December 20X7 for £250,000. On that date the replacement cost of an electrical component was £11.50. The general rate of inflation as measured by the general price index was 12% during the year. Profit could be calculated as follows:

	Financial cap. maint'nce (monetary terms) £	Financial cap. maint'nce (constant purchasing power) £	Physical cap. maint'nce £
Revenue	250,000	250,000	250,000
Cost of sales			
20,000 × 10	(200,000)		
20,000 × 11.2		(224,000)	
20,000 × 11.5			(230,000)
Profit	50,000	26,000	20,000

3 Other reporting frameworks

Section overview

- This Workbook (and your exam) focuses on IFRS, but there are other reporting frameworks you need to know about, particularly those that relate to smaller entities.
- The IASB's IFRS for small and medium-sized entities (SMEs) is designed to facilitate financial reporting by small and medium-sized entities in a number of ways.

3.1 Small and medium-sized enterprises (SMEs)

3.1.1 Scope and application of IFRS

Any limitation of the applicability of a specific IFRS is made clear within that standard. IFRS are **not intended to be applied to immaterial items, nor are they retrospective**. Each individual IFRS lays out its scope at the beginning of the standard.

Within each individual country **local regulations** govern, to a greater or lesser degree, the issue of financial statements. These local regulations include accounting standards issued by the national regulatory bodies and/or professional accountancy bodies in the country concerned.

IFRS **concentrates on essentials** and is designed not to be too complex, otherwise the standards would be impossible to apply on a worldwide basis.

IFRS does not override local regulations on financial statements. Entities should simply disclose whether IFRS is complied with in all material respects. Entities in individual countries will attempt to persuade local authorities, where current regulations deviate from IFRS, that the benefits of harmonisation make local change worthwhile.

3.1.2 Application of IFRS to smaller entities Big GAAP/little GAAP divide

In most countries the majority of companies or other types of entity are **very small**. They are generally owned and managed by one person or a family. The owners have invested their own money in the business and there are no outside shareholders to protect.

Large entities, by contrast, particularly companies listed on a stock exchange, may have shareholders who have invested their money, possibly through a pension fund, with no knowledge whatsoever of the company. These shareholders need protection and the regulations for such companies need to be more stringent.

It could therefore be argued that company accounts should be of two types.

(a) 'Simple' ones for small companies with fewer regulations and disclosure requirements

(b) 'Complicated' ones for larger companies with extensive and detailed requirements

This is sometimes called the **big GAAP/little GAAP divide**.

Possible solutions

There are two approaches to overcoming the big GAAP/little GAAP divide:

(a) Differential reporting ie, producing new reduced standards specifically for smaller companies, such as the IFRS for SMEs (see below)

(b) Providing exemptions for smaller companies from some of the requirements of existing standards

Differential reporting

Differential reporting may have drawbacks in terms of reducing comparability between small and larger company accounts.

Furthermore, problems may arise where entities no longer meet the criteria to be classified as small.

Exemptions from IFRS

Some IFRS Standards do not have any bearing on small company accounts; for example, a company with equity not quoted on a stock exchange has no need to comply with IAS 33, *Earnings per Share*. Also, an entity with a small local market may find IFRS 8, *Operating Segments* to be superfluous.

Other standards always have an impact. In particular, almost all small companies will be affected by the IFRS Standards on the following:

- Property, plant and equipment
- Inventories
- Presentation of financial statements
- Events occurring after the reporting period
- Taxes on income
- Revenue
- Provisions and contingencies

Does this mean that companies below a certain size should be exempt from other IFRS? An alternative approach would be to reduce the exposure of small companies to IFRS on a **standard by standard basis**. For those 'core' standards listed above, small companies would be required to follow all or most of their provisions. For more complicated standards, small companies would face nothing but very brief general obligations.

It is difficult to see how the IASB could impose any kind of specific size limits to define small companies if such an approach were adopted. Instead, it might specify that size limits which are already given in national legislation or standards could be adopted for the purpose.

Cost of compliance

If the cost of compliance exceeds the benefits to users, an entity may decide not to follow an IFRS. This applies to all reporting entities, not just smaller ones. However, smaller entities are more likely to make use of this exception.

For example, impairment reviews can be time consuming and a smaller entity may not have sufficient staff to spare to carry out these reviews.

Materiality

Another point to note is that IFRS Standards apply to **material** items. In the case of smaller entities, the amount that is material may be very small in monetary terms. However, the effect of not reporting that item may be material in that it would mislead users of the financial statements. A case in point is IAS 24, *Related Party Disclosures*. Smaller entities may well rely on trade with relatives of the directors/shareholders and this needs to be disclosed.

3.1.3 International Financial Reporting Standard for Small and Medium-sized Entities

The *IFRS for Small and Medium-Sized Entities* (IFRS for SMEs) was published in 2009 and revised in 2015 and 2018. It is relatively short, and has simplifications that reflect the needs of users of SMEs' financial statements and cost-benefit considerations.

It is designed to facilitate financial reporting by SMEs in a number of ways.

- It provides significantly less guidance than full IFRS.

- Many of the principles for recognising and measuring assets, liabilities, income and expenses in full IFRS are simplified.
- Where full IFRS allows accounting policy choices, the IFRS for SMEs allows only the easier option.
- Topics not relevant to SMEs are omitted.
- Significantly fewer disclosures are required.
- The standard has been written in clear language that can easily be translated.

3.1.4 Scope

The IFRS is suitable for all entities except those whose securities are publicly traded and financial institutions such as banks and insurance companies. It is the first set of international accounting requirements developed specifically for SMEs. Although it has been prepared on a similar basis to full IFRS, it is a standalone product and will be updated on its own timescale.

There are no quantitative thresholds for qualification as an SME; instead, the scope of the IFRS is determined by a test of public accountability. As with full IFRS, it is up to legislative and regulatory authorities and standard setters in individual jurisdictions to decide who is permitted or required to use the IFRS for SMEs.

3.1.5 Effective date

The IFRS for SMEs does not contain an effective date; this is determined in each jurisdiction. The IFRS will be revised only once every three years. It is hoped that this will further reduce the reporting burden for SMEs.

3.1.6 Accounting policies

For situations where the IFRS for SMEs does not provide specific guidance, it provides a hierarchy for determining a suitable accounting policy. An SME must consider, in descending order:

- The guidance in the IFRS for SMEs on similar and related issues
- The definitions, recognition criteria and measurement concepts in section 2 *Concepts and Pervasive Principles* of the standard

The entity also has the option of considering the requirements and guidance in full IFRS dealing with similar topics. However, it is under no obligation to do this, or to consider the pronouncements of other standard setters.

3.1.7 Overlap with full IFRS

In the following areas, the recognition and measurement guidance in the IFRS for SMEs is like that in the full IFRS.

- Provisions and contingencies
- Hyperinflation accounting
- Events after the end of the reporting period
- Taxation
- Property, plant and equipment

3.1.8 Omitted topics

The IFRS for SMEs does not address the following topics that are covered in full IFRS.

- Earnings per share
- Interim financial reporting
- Segment reporting
- Classification for non-current assets (or disposal groups) as held for sale

3.1.9 Examples of options in full IFRS not included in the IFRS for SMEs

- Revaluation model for intangible assets and property, plant and equipment
- Financial instrument options, including investments in equity interests, held-to-maturity and fair value options
- Choice between cost and fair value models for investment property (measurement depends on the circumstances)
- Options for government grants

3.1.10 Principal recognition and measurement simplifications

(a) **Financial instruments**

Financial instruments meeting specified criteria are measured at cost or amortised cost. All others are measured at fair value through profit or loss. The procedure for derecognition has been simplified, as have hedge accounting requirements.

(b) **Goodwill and other indefinite-life intangibles**

These are always amortised over their estimated useful life (or 10 years if it cannot be estimated).

(c) **Investments in associates and joint ventures**

These can be measured at cost, but fair value must be used if there is a published price quotation.

(d) **Research and development costs and borrowing costs** must be expensed.

(e) **Held-for-sale assets**

There is no separate held-for-sale classification; holding an asset or group of assets for sale is an indicator of impairment.

(f) **Biological assets**

SMEs are to use the cost less depreciation and impairment model unless the fair value is readily determinable, in which case the fair value through profit or loss model is required.

(g) **Equity-settled share-based payment**

If observable market prices are not available to measure the fair value of the equity-settled share-based payment, the directors' best estimate is used.

3.1.11 The future of the IFRS for SMEs

Because there is no supporting guidance in the IFRS for SMEs, differences from the full IFRS have arisen, even where the principles are the same. Most of the exemptions in the IFRS for SMEs are on grounds of cost or undue effort. However, despite the practical advantages of a simpler reporting framework, there will be costs involved for those moving to the IFRS – even a simplified IFRS – for the first time.

3.1.12 Advantages and disadvantages of the IFRS for SMEs Advantages

- It is virtually a '**one stop shop**'.
- It is **structured according to topics**, which should make it practical to use.
- It is written in an **accessible style**.
- There is **considerable reduction in disclosure requirements**.
- Guidance **not relevant** to private entities is **excluded**.

Disadvantages

- It does not focus on the smallest companies.
- The scope extends to 'non publicly accountable' entities. Potentially, the scope is too wide.

- The standard will be onerous for small companies.
- Further simplifications could be made. These might include the following:
  - Amortisation for goodwill and intangibles
  - No requirement to value intangibles separately from goodwill on a business combination
  - No recognition of deferred tax
  - No measurement rules for equity-settled share-based payment
  - No requirement for consolidated accounts (as for EU SMEs currently)
  - Fair value measurement when readily determinable without undue cost or effort

3.2 Auditing smaller entities

3.2.1 International standards on auditing for small companies

Unlike the IFRS Standards, there are no separate auditing standards applying specifically to smaller entities. This is based on the view that 'an audit is an audit' and that users who receive auditors' reports need to have confidence in the auditor's opinions, whether they are in relation to large or small entity financial statements.

However, there is an acknowledgement that small and medium enterprises do pose specific challenges to the auditor in certain areas. Some of the ISAs that you have already studied highlight how their requirements should be applied to small company audits.

Note: Recent revisions to auditing standards have moved away from stating **considerations relevant to smaller entities** and instead introduced the idea of **scalability** which is designed to allow ISAs to be applied proportionately to the **scale** and **complexity** of risks presented by a particular audit engagement, **regardless of its size**. In other words, large engagements may not be considered as complex as some comparatively smaller engagements, perhaps as a result of the absence of robust systems of internal control. The following guidance reflects the current position of how ISAs advise auditors to address the challenges of auditing smaller entities.

3.2.2 ISA 210, *Agreeing the Terms of Audit Engagements*

The owner of a small company may not be aware of directors' and auditors' responsibilities, particularly if the accounts preparation is outsourced. A primary purpose of the **engagement letter** is to clarify these responsibilities. ISA 210.A21 states that it may be useful in this situation to remind management that the preparation of the financial statements remains their responsibility.

3.2.3 ISA 220 (Revised), *Quality Management for an Audit of Financial Statements*

The audit of a smaller entity must still be compliant with ISAs. However, many smaller engagements may be conducted by smaller firms that are unable to meet the specific requirements of ISQM 1 and 2 and ISA 220 (Revised), such as supervision and review, due to insufficient staffing in the firm. In such cases, quality management may be undertaken on a more ad-hoc basis.

3.2.4 ISA 230, *Audit Documentation*

A small audit team may have an excellent understanding of the audit client, but it is important to ensure that working papers **meet the standard required by the ISA** and to prepare audit documentation that can be understood by an experienced auditor, as the documentation may be subject to review by external parties for regulatory or other purposes.

The standard (ISA 230.A16–.A17) does allow for the following:

(a) The documentation being less extensive than for the audit of a larger entity

(b) Where the engagement partner performs all the audit work, matters that are normally documented solely to instruct or inform members of the team, or to provide evidence of review, will not be included

(c) Various aspects of the audit may be recorded together in a single document

3.2.5 ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

Within small companies, the **lack of control procedures** can contribute to a higher risk of employee fraud and error. On the other hand, a smaller entity may not have a written code of conduct but may have developed a culture of integrity and ethical behaviour through oral communication and management example.

The presence of a dominant owner-manager can be an important factor in the overall control environment, with the need for management authorisation compensating for the lack of other controls. However, this can be a potential deficiency in internal control, due to the opportunity for management to override controls.

ISA 240 requires discussion among the audit team of the **susceptibility of the entity to material frauds or errors**. This discussion is still required for a small entity but is often overlooked due to the size of the audit team.

In addition, ISA 240 requires auditors to ask management about their assessment of risk of fraud and error. Even if management do not have a system of assessing risk, the enquiry should still be made, as it provides valuable information about the control environment, although in smaller entities management's assessment may only focus on the risks of employee fraud or misappropriation of assets. (ISA 240.A14)

3.2.6 ISA 300, *Planning an Audit of Financial Statements*

Due to the lack of complexity, **audit planning documentation** may be **scaled back** for a small entity. With a smaller team, co-ordination and communication are easier. A planning meeting or general conversation may be sufficient, and notes made about future issues during last year's audit will be particularly useful.

Standard audit programmes or checklists may be used, provided that they are tailored to the circumstances of the engagement, including the auditor's risk assessments.

In the smallest audits, carried out entirely by the audit partner, questions of direction, supervision and review do not arise. Forming an objective view on the appropriateness of judgements made in the course of the audit can present problems in this case and, if particularly complex or unusual issues are involved, it may be desirable to consult with other suitably experienced auditors or the auditor's professional body. (ISA 300.A11, A13, A14, A23)

3.2.7 ISA 320, *Materiality in Planning and Performing an Audit*

The standard highlights that in an owner-managed business the profit before tax for the year may be consistently nominal, as the owner may take most of the profits as remuneration, so it may be more appropriate to use profit before remuneration as the basis for estimating materiality. (ISA 320.A9)

Another practical issue is that at the planning stage it is often difficult to calculate materiality as a percentage of key figures eg, of assets, revenue or profit, as the draft accounts may be unavailable for a small business. Trial balance figures may have to be used instead.

The auditor will need to use **judgement** in applying materiality when evaluating results.

3.2.8 ISA 550, *Related Parties*

In a small entity, related party transactions between the company and its directors and their families may be **significant** but smaller entities may have no documented processes or controls for dealing with related party relationships and transactions. The auditor will have to obtain an understanding of the related party relationships and transactions through enquiry of management and observation of management's oversight and review activities. (ISA 550.A20)

The auditor's in-depth knowledge of the smaller entity will assist in identification of related parties (for example, other entities controlled by the owner management) which will also help the auditor to assess the risk of any transactions being unrecorded or undisclosed.

3.2.9 ISA 570 (Revised), Going Concern

The size of an entity may affect its ability to withstand adverse conditions. Small entities may be able to respond quickly to exploit opportunities, but may lack reserves to sustain operations.

Risks of particular relevance to small entities are:

- that banks and other lenders may cease to support the entity; and
- the possible loss of a principal supplier, major customer or key employee, or of the right to operate under a licence, franchise or other legal agreement. (ISA 570.A5–.A6)

It is unlikely that budgets and forecasts will be available for the auditor to review. In many businesses the principal source of finance may be a loan from the owner-manager.

If an entity is in difficulty, its survival may depend on the owner-manager subordinating their loan in favour of banks or other financial institutions. In this case, the auditor would inspect sufficient, appropriate evidence of the subordination.

If an entity depends on funds from the owner-manager, the auditor will consider their current financial position and may ask for a written representation to confirm the owner-manager's understanding. (ISA 570.A12-.A13)

4 IFRS 13, *Fair Value Measurement*

Section overview

- IFRS 13, *Fair Value Measurement* gives extensive guidance on how the fair value of assets and liabilities should be established.
- IFRS 13 aims to:
  - define fair value
  - set out in a single IFRS a framework for measuring fair value
  - require disclosures about fair value measurements
- IFRS 13 defines fair value as "**the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date**".
- Fair value is a market-based measurement, not an entity-specific measurement. It focuses on assets and liabilities and on exit (selling) prices. It also takes into account market conditions at the measurement date.
- IFRS 13 states that valuation techniques must be those which are appropriate and for which sufficient data are available. Entities should maximise the use of relevant **observable inputs** and minimise the use of **unobservable inputs**.

4.1 Background

IFRS 13, *Fair Value Measurement* was published in 2011.The project arose as a result of the Memorandum of Understanding between the IASB and FASB (2006) reaffirming their commitment to the convergence of IFRS and US GAAP. With the publication of IFRS 13, IFRS and US GAAP now have the same definition of fair value and the measurement and disclosure requirements are now aligned. A standard on fair value measurement is particularly important in the context of a worldwide move towards IFRS.

4.2 Objective

IFRS 13 aims to:

- define fair value
- set out in a single IFRS a framework for measuring fair value
- require disclosures about fair value measurements

The previous definition used in IFRS was "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction".

The price which would be received to sell the asset or paid to transfer (not settle) the liability is described as the 'exit price' and this is the definition used in US GAAP. Although the concept of the 'arm's length transaction' has now gone, the market-based current exit price retains the notion of an exchange between unrelated, knowledgeable and willing parties.

4.3 Scope

IFRS 13 applies when another IFRS requires or permits fair value measurements or disclosures. The measurement and disclosure requirements do not apply in the case of:

(a) share-based payment transactions within the scope of IFRS 2, *Share-based Payment;*

(b) leasing transactions within the scope of IFRS 16, *Leases*; and

(c) net realisable value as in IAS 2, *Inventories* or value in use as in IAS 36, *Impairment of Assets.*

Disclosures are not required for:

(a) plan assets measured at fair value in accordance with IAS 19, *Employee Benefits;*

(b) plan investments measured at fair value in accordance with IAS 26, *Accounting and Reporting by Retirement Benefit Plans*; and

(c) assets for which the recoverable amount is fair value less disposal costs under IAS 36, *Impairment of Assets*.

4.4 Measurement

Fair value is a market-based measurement, not an entity-specific measurement. It focuses on assets and liabilities and on exit (selling) prices. It also takes into account market conditions at the measurement date. In other words, it looks at the amount for which the holder of an asset could sell it and the amount which the holder of a liability would have to pay to transfer it. It can also be used to value an entity's own equity instruments.

Because it is a market-based measurement, fair value is measured using the assumptions that market participants would use when pricing the asset, taking into account any relevant characteristics of the asset.

It is assumed that the transaction to sell the asset or transfer the liability takes place either:

(a) in the **principal market** for the asset or liability; or

(b) in the absence of a principal market, in the **most advantageous** market for the asset or liability.

The principal market is the market which is the most liquid (has the greatest volume and level of activity) for that asset or liability. In most cases the principal market and the most advantageous market will be the same.

IFRS 13 acknowledges that when market activity declines, an entity must use a valuation technique to measure fair value. In this case the emphasis must be on whether a transaction price is based on an **orderly transaction**, rather than a forced sale.

Fair value is **not adjusted for transaction costs.** Under IFRS 13, these are **not a feature of the asset or liability**, but may be taken into account when **determining the most advantageous market**.

Fair value measurements are based on an asset or a liability's **unit of account**, which is specified by each IFRS where a fair value measurement is required. For most assets and liabilities, the unit of account is the individual asset or liability, but in some instances may be a group of assets or liabilities.

Context example: Unit of account

A premium or discount on a large holding of the same shares (because the market's normal daily trading volume is not sufficient to absorb the quantity held by the entity) is not considered when measuring fair value: the quoted price per share in an active market is used.

However, a control premium is considered when measuring the fair value of a controlling interest, because the unit of account is the controlling interest. Similarly, any non-controlling interest discount is considered where measuring a non-controlling interest.

Context example: Principal (or most advantageous) market

An asset is sold in two active markets, Market X and Market Y, at £58 and £57 respectively. Valor Co does business in both markets and can access the price in those markets for the asset at the measurement date as follows.

	Market X	**Market Y**
	£	**£**
Price	58	57
Transaction costs	(4)	(3)
Transport costs (to transport the asset to that market)	(4)	(2)
	50	52

Remember that fair value is not adjusted for transaction costs. Under IFRS 13, these are not a feature of the asset or liability, but may be taken into account when determining the most advantageous market.

If Market X is the principal market for the asset (ie, the market with the greatest volume and level of activity for the asset), the fair value of the asset would be £54, measured as the price that would be received in that market (£58) less transport costs (£4) and ignoring transaction costs.

If neither Market X nor Market Y is the principal market for the asset, Valor must measure the fair value of the asset using the price in the most advantageous market. The most advantageous market is the market that maximises the amount that would be received to sell the asset, after taking into account both transaction costs and transport costs (ie, the net amount that would be received in the respective markets).

The maximum net amount (after deducting both transaction and transport costs) is obtainable in Market Y (£52, as opposed to £50). But this is not the fair value of the asset. The fair value of the asset is obtained by deducting transport costs but not transaction costs from the price received for the asset in Market Y: £57 less £2 = £55.

4.4.1 Non-financial assets

For **non-financial assets** the fair value measurement looks at the use to which the asset can be put. It takes into account the ability of a market participant to generate economic benefits by using the asset in its **highest and best** use.

4.5 Valuation techniques

IFRS 13 states that valuation techniques must be those which are appropriate and for which sufficient data are available. Entities should maximise the use of relevant **observable inputs** and minimise the use of **unobservable inputs**.

The standard establishes a three-level hierarchy for the inputs that valuation techniques use to measure fair value:

- **Level 1** Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date.
- **Level 2** Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly eg, quoted prices for similar assets in active markets or for identical or similar assets in non-active markets or use of quoted interest rates for valuation purposes.
- **Level 3** Unobservable inputs for the asset or liability ie, using the entity's own assumptions about market exit value.

Professional skills focus: Structuring problems and solutions

This hierarchy is a starting place for structuring the problem of fair value. If the input is level 1, there should not be much of a problem.

4.5.1 Valuation approaches

The IFRS identifies **three valuation approaches**.

(a) **Income approach.** Valuation techniques that convert future amounts (eg, cashflows or income and expenses) to a single current (ie, discounted) amount. The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts.

(b) **Market approach.** A valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable (ie, similar) assets, liabilities or a group of assets and liabilities, such as a business.

(c) **Cost approach.** A valuation technique that reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).

Entities may use more than one valuation technique to measure fair value in a given situation. A change of valuation technique is considered to be a change of accounting estimate in accordance with IAS 8, and must be disclosed in the financial statements.

4.5.2 Examples of inputs used to measure fair value

	Asset or liability	Input
Level 1	Equity shares in a listed company	Unadjusted quoted prices in an active market

	Asset or liability	Input
Level 2	Licensing arrangement arising from a business combination	Royalty rate in the contract with the unrelated party at inception of the arrangement
	Cash generating unit	Valuation multiple (eg, a multiple of earnings or revenue or a similar performance measure) derived from observable market data eg, from prices in observed transactions involving comparable businesses
	Finished goods inventory at a retail outlet	Price to customers adjusted for differences between the condition and location of the inventory item and the comparable (ie, similar) inventory items
	Building held and used	Price per square metre derived from observable market data eg, prices in observed transactions involving comparable buildings in similar locations
Level 3	Cash generating unit	Financial forecast (eg, of cash flows or profit or loss) developed using the entity's own data
	Three-year option on exchange- traded shares	Historical volatility ie, the volatility for the shares derived from the shares' historical prices
	Interest rate swap	Adjustment to a mid-market consensus (non-binding) price for the swap developed using data not directly observable or otherwise corroborated by observable market data

4.6 Measuring liabilities

Fair value measurement of a liability assumes that the liability is transferred at the measurement date to a market participant, who is then obliged to fulfil the obligation. The obligation is not settled or otherwise extinguished on the measurement date.

4.6.1 Entity's own credit risk

The fair value of a liability reflects the effect of **non-performance risk,** which includes but is not limited to **the entity's own credit risk.** This may be different for different types of liability.

Context example: Entity's own credit risk

Black Co and Blue Co both enter into a legal obligation to pay £20,000 cash to Green Co in seven years.

Black Co has a top credit rating and can borrow at 4%. Blue Co's credit rating is lower and can borrow at 8%.

Black Co will receive approximately £15,200 in exchange for its promise. This is the present value of £20,000 in seven years at 4%.

Blue Co will receive approximately £11,700 in exchange for its promise. This is the present value of £20,000 in seven years at 8%.

4.7 IFRS 13 and business combinations

Fair value generally applies on a business combination. This topic is covered in Chapter 20, together with some further examples.

4.8 Disclosure

An entity must disclose information that helps users of its financial statements assess both of the following:

(a) For assets and liabilities that are measured at fair value on a recurring or non-recurring basis, the valuation techniques and inputs used to develop those measurements

(b) For recurring fair value measurements using significant **unobservable inputs** (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period. Disclosure requirements will include:

- reconciliation from opening to closing balances
- quantitative information regarding the inputs used
- valuation processes used by the entity
- sensitivity to changes in inputs

Professional skills focus: Concluding, recommending and communicating

Particularly with Level 3 inputs, it is important to explain why you came to the conclusion that you did. The disclosures above help to do this.

5 IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*

Section overview

This is an overview of material covered in earlier studies

5.1 Fair accounting policies

(a) Accounting policies are determined by **applying the relevant IFRS or IFRIC** and considering any relevant Implementation Guidance issued by the IASB for that IFRS/IFRIC.

(b) Where there is no applicable IFRS or IFRIC management should use its **judgement** in developing and applying an accounting policy that results in information that is **relevant** and **reliable**. Management should refer to:

(1) the requirements and guidance in IFRS Standards and IFRICs dealing with **similar** and **related issues**; and

(2) the definitions, recognition criteria and measurement concepts for assets, liabilities and expenses in the *Framework*. Management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop standards, other accounting literature and accepted industry practices if these do not conflict with the sources above.

(3) An entity shall select and apply its accounting policies for a period **consistently** for similar transactions, other events and conditions, unless an IFRS or an IFRIC specifically requires or permits categorisation of items for which different policies may be appropriate. If an IFRS or an IFRIC requires or permits categorisation of items, an appropriate accounting policy shall be selected and applied consistently to each category.

5.2 Changes in accounting policies

(a) These are **rare**: only if required by statute/standard-setting body/results in reliable and more relevant information.

(b) **Adoption of new IFRS**: follow transitional provisions of IFRS. If no transitional provisions: **retrospective** application.

(c) **Other changes in policy**: **retrospective** application. Adjust opening balance of each affected component of equity ie, as if new policy has always been applied.

(d) **Prospective** application: this is **not allowed** unless it is **impracticable** to determine the cumulative effect of the change.

(e) **Disclosure**: an entity should **disclose** information relevant to assessing the **impact of new IFRS Standards/IFRICs** on the financial statements where these have been **issued but have not yet come into force**.

5.3 Changes in accounting estimates

- Estimates arise because of **uncertainties inherent within them**; judgement is required but this does not undermine reliability.
- Effect of a change in accounting estimate should be included in profit or loss in:
  - period of change, if change affects only current period; or
  - period of change and future periods, if change affects both.

5.4 Errors

(a) Prior period errors: correct retrospectively where material.

(b) This involves:

(1) either restating the comparative amounts for the prior period(s) in which the error occurred; or

(2) when the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for that period so that the financial statements are presented as if the error had never occurred.

(c) Only where it is **impracticable** to determine the cumulative effect of an error on prior periods can an entity correct an error **prospectively**.

Interactive question 2: Accounting errors

During 20X7 Lubi Co discovered that certain items had been included in inventory at 31 December 20X6, valued at £4.2 million, which had in fact been sold before the year end. The following figures for 20X6 (as reported) and 20X7 (draft) are available.

	20X6	20X7 (draft)
	£'000	£'000
Sales	47,400	67,200
Cost of goods sold	(34,570)	(55,800)
Profit before taxation	12,830	11,400
Income taxes	(3,880)	(3,400)
Net profit	8,950	8,000

Retained earnings at 1 January 20X6 were £13 million. The cost of goods sold for 20X7 includes the £4.2 million error in opening inventory. The income tax rate was 30% for 20X6 and 20X7.

Requirement

Show the profit or loss section of the statement of profit or loss and other comprehensive income for 20X7, with the 20X6 comparative, and retained earnings.

See **Answer** at the end of this chapter.

5.5 Recent development: definition of material

IAS 8 was amended to align the definitions of material in IAS 8 and IAS 1. This definition was extended to the *Materiality Practice Statement* (see below) and to the *Conceptual Framework*.

Definition

Material: Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report.' (IAS 1: para. 7)

6 Current issues in corporate reporting

Section overview

This section covers several areas in which both the IASB and IFRS Foundation are developing new accounting standards. Recent changes are ripe for examination if they are the subject of a full IFRS. While proposed changes (EDs, Discussion Papers) will not be examined in detail, it is important to show an awareness of them.

Important note

Current issues are covered in this Workbook within the chapters in which the topic appears, so that the changes/proposed changes appear in context. Sustainability has been introduced here, but you will find further examples of how it is relevant to corporate reporting in subsequent chapters.

6.1 Better communication in financial reporting

Since 2015, a major theme of the IASB's work has been to improve communication in financial reporting. This is in response to feedback from users of financial statements that financial statements can be poorly presented, making it time-consuming and difficult for users to identify useful information. This topic is covered in more detail in Chapter 24 in the context of the Management Commentary.

6.2 Sustainability

It is extremely likely that you will have heard of this topic – the idea of sustainability has existed in various forms for many years – but perhaps the most straightforward definition comes from the United Nations (UN) in its 1987 Brundtland Commission report:

Definition

Sustainability: Meeting the needs of the present without compromising the ability of future generations to meet their own needs (UN, 2021).

Many argue that environmental issues, embracing both **sustainability** and other related issues such as **climate change**, are the single most important threat to the world. The acronym ESG is therefore becoming more prevalent for all organisations to be aware of and to engage with – although it stands for Environmental, Social and Governance, the topic extends to consider things from an **ethical** and **sustainability** perspective as well. With so many issues to address and the global stakes so high, agreement on how to deal with ESG issues is challenging.

Recent progress has been mixed, with many different solutions to what is clearly a global issue, but there is hope that progress is being made. From the **Paris Agreement** at the UN climate change conference COP 21 in 2015, which introduced a legal requirement signed by almost 200 countries to keep global warming to between 1.5 and 2 degrees Celsius, to the emergence of more militant responses, such as the **Extinction Rebellion** movement, this issue continues to dominate the public narrative.

ICAB Chartered Accountants need to recognise that sustainability is at the **core** of what they do and analyse how to make the sustainable economy work for **business**, for **clients** and the **public interest**.

To achieve this, ICAB Chartered Accountants and Assurance professionals need to move beyond simply measuring and reporting the impact of climate change, environmental regulation, supply chain pressure and rising energy costs. They will be expected to focus on understanding those implications and advising on the broader implications of ESG issues for organisations.

Sustainability impacts across all modules of the ACA qualification. For **Corporate Reporting**, this impacts the following five areas:

(a) Reporting

(b) Risk management

(c) Strategy

(d) Governance

(e) Metrics and targets

As well as the impact on companies, ICAB Chartered Accountants need to work with a wide range of other **stakeholders** to deliver solutions to the issues related to sustainability, including boards of directors, business partners, employees, market analysts, suppliers, customers, governments, lenders, the general public and local communities. From an assurance perspective, in the future, stakeholders may require or be entitled to verified information disclosed by companies, which may need to be audited or undergo a specific assurance engagement.

Reporting

The purpose of a set of financial statements is to **inform users** of the position, performance and prospects of an organisation, mainly in financial terms but also in more qualitative terms if such information is best conveyed in that manner. ESG disclosures can obviously fall into this qualitative category, but there is now a greater need for the implications of an organisation's ESG matters to be considered when determining its **value** and any relevant **investment decisions**. Consequently, being able to understand which ESG matters should be disclosed and what they might mean are now a prime focus for both preparers and auditors of published corporate information.

Risk management

Climate change is clearly giving rise to significant risks for businesses. Whether those risks arise from more frequent and severe weather events or the transition to a net-zero carbon economy, expectations are growing that companies appropriately embed climate-related financial risk into their governance and risk management processes. **Scenario analysis** is key to better understanding and managing future risks today, as well as supporting the transition to a net-zero carbon economy. The accountancy and assurance profession has a particular interest in the topic of risk, notably the identification, measurement and management of business and financial risk, including reputation risks that may threaten the survival of an enterprise. A mature company is now expected to recognise that environmental and social matters are recognised and integrated into its risk management and reporting infrastructures.

Strategy

As a matter of strategy, the **assessment** of business initiatives should take account of environmental, social and economic impacts. Conversely, the **impact** of business initiatives on the environment, society and the economy also needs to be considered. Enhancing sustainability is an essential part of running a good business and the impacts of each dimension need to be managed in an **integrated way** so that social, environmental and economic decisions contribute to the development of the business in delivering long-term benefits.

The increasing demands of the disclosure framework, coupled with the undeniable impacts of sustainability and climate-related risks, mean that a company can no longer just **assume** that ESG factors will be taken care of automatically. Directors therefore need to consider the impact of the company's operations, policies, products and procurement practices on the environment and on social and community issues, including impacts of its operations on the communities affected.

Governance

Effective stakeholder engagement is dependent on **reliable information**. This is likely to be a matter of increasing concern with the demand for transparency of information to support the process of feedback with stakeholders. Preparing for, and responding to, stakeholder engagement will often call for social, environmental and economic data. Assurance engagements may be particularly useful in advising on governance required to provide social, environmental and economic data both within the company and to external stakeholders.

Metrics and targets

Effective measuring of ESG performance data and benchmarking requires the **timely publication of information**.

Assurance experts may be expected to:

- Take a role in **advising** on future supporting measurement of climate change and its consequences by providing relevant and reliable information in an accessible, meaningful and comparable way.
- **Interpret** the results of ESG related performance measures against targets. This is likely to include understanding the different bases used to be able to compare and analyse the results.

6.2.1 Sustainability and reporting

We will return to the topic of sustainability later in these materials when we consider environmental and social considerations. For now, it is important to frame **sustainability** and **climate change** in the context of **corporate reporting**.

In recent years, we have seen a number of developments in this area, driven by the formation and amalgamation of a number of organisations. Here are the key players you need to know about and how they fit together:

The **Climate Disclosure Standards Board** (CDSB) was set up in 2007 to address the need to understand how both natural and financial capital could be disclosed under the existing corporate reporting framework.
The **International Integrated Reporting Council** (IIRC) was formed in 2010 to promote a reporting framework that used six interlocking capitals to identify how organisations use various resources in order to create value.
The **Sustainability Accounting Standards Board** (SASB) was formed in 2011 to help entities understand the impact of sustainability on finance.
In 2021, the IIRC and SASB merged to become the **Value Reporting Foundation** (VRF) with the remit of supporting a more complete view of how value is created by organisations.
The **International Sustainability Standards Board** (ISSB) was formed by the IFRS Foundation after the UN COP 26 towards the end of 2021 using the **Taskforce on Climate-related Financial Disclosures** (TCFD) reporting approach (see below) which is mandatory for premium listed entities in the UK.
During 2022, the VRF and CDSB were both consolidated into the IFRS Foundation under the banner of the ISSB.

According to the IFRS Foundation website:

"The intention is for the ISSB to deliver a comprehensive global baseline of sustainability-related disclosure standards that provide investors and other capital market participants with information about companies' sustainability-related risks and opportunities to help them make informed decisions." (IFRS Foundation, 2021)

Since its inception at the start of 2022, the ISSB has hit the ground running. Between March and July 2022, the ISSB sought **consultation** on its first two standards (IFRS S1 and S2) by issuing **exposure drafts** supported by other documentation (including a basis for conclusions and illustrative guidance). In June 2023 the standards were promulgated to be effective from 1 January 2024. **IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information***

Sustainability-related financial **disclosures** is defined as:

A particular form of general purpose financial reports that provide information about the reporting entity's sustainability related risks and opportunities that could reasonably be expected to affect the entity's cash flows, its access to finance or cost of capital over the short, medium or long term, including information about the entity's governance, strategy and risk management in relation to those risks and opportunities, and related metrics and targets.

IFRS S1: Appendix A

An entity need not disclose information otherwise required by an IFRS Sustainability Disclosure Standard if the information is not material. This is the case even if the IFRS Sustainability Disclosure Standard contains a list of specific requirements or describes them as minimum requirements (IFRS S1: para.B26).

Objective

The objective of IFRS S1 is:

To require an entity to disclose information about its significant sustainability-related risks and opportunities that is useful to the primary users of general purpose financial reporting when they assess enterprise value and decide whether to provide resources to the entity.

IFRS S1: para.1

So, in other words, how do sustainability-related risks and opportunities affect the **value** of an entity and do they make it **more or less attractive to investors**?

Risks and opportunities are driven by the consideration of factors such as whether an organisation or its stakeholders depends on a particular natural resource (eg, water) which may have an adverse effect on value if there are issues with the supply, quality or price of that resource; similarly the value of an entity may also be affected if it generates adverse impacts (such as affecting a local community) which open it up to more stringent regulation or reputational damage. These dependencies and impacts might give rise to sustainability-related risks and opportunities that could reasonably be expected to affect an entity's cashflows, its access to finance and cost of capital over the short, medium and long term (IFRS S1: para.B2).

Scope

Sustainability-related risks and opportunities that could not reasonably be expected to affect an entity's prospects are outside the scope of this Standard.

Core content

These adapt the core elements of climate-related financial disclosures recommended by the TCFD to allow consideration of sustainability-related risks and opportunities instead. The TCFD methodology is covered again later in this Workbook but in overview, the four categories are as follows:

Governance

The organisation's governance around climate-related risks and opportunities

Strategy

The actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy and financial planning

Risk management

The processes used by the organisation to identify, assess, and manage climate- related risks

Metrics and targets

The metrics and targets used to assess and manage relevant climate-related risks and opportunities

General features

(a) **Reporting entity** – this should be the same as the entity reporting general purpose financial statements.

(b) **Connected information** – both sustainability-related and general purpose financial information should be connected to allow users to understand the reporting entity as a whole (so any decisions made will disclose both financial and sustainability-based impacts).

(c) **Fair presentation** – information should be "relevant, representationally faithful, comparable, verifiable, timely and understandable" (ED IFRS S1: para.47) with additional disclosure if either strict adoption or the absence of an appropriate reporting standard leads to users being inadequately informed about sustainability-related risks and opportunities and their impacts on the entity's value.

(d) **Materiality** – sustainability-related financial information is considered material if omitting, misstating or obscuring it would reasonably be expected to affect the decisions made by users of the information.

(e) **Comparative information** – any metrics used as part of sustainability-related financial information should cover both current and previous periods, including qualitative disclosures for both periods if it helps to support users' understanding.

(f) **Frequency of reporting** – this should be equivalent to the reporting timetable for general purpose financial statements.

(g) **Location of information** – unless specifically required by laws or regulations, sustainability-related financial information can be reported in a variety of locations but must form an obvious component of the entity's general purpose financial statements.

(h) **Sources of estimation and outcome uncertainty** – all financial information, whether general purpose or sustainability-related, can contain aspects where there is estimation uncertainty, so disclosure of relevant assumptions and estimation uncertainty is required (this extends to uncertainty over the possible outcome of any risks or opportunities).

(i) **Errors** – should any prior period sustainability-related financial information be found to have contained misstatements or omissions, they should be restated unless it is impractical to do so.

(j) **Statement of compliance** – an explicit and unqualified statement that sustainability-related financial information complies with the IFRS sustainability disclosure standards is required unless prohibited by local laws or regulations (IFRS S1: paras.25-86).

Appendices

The standard contains appendices that provide a **definition** of the terms used throughout, the proposed **effective date** and the **qualitative characteristics** of useful sustainability-related financial information, split into two categories:

- **Fundamental** qualitative characteristics (relevance, materiality and faithful representation)
- **Enhancing** qualitative characteristics (comparability, verifiability, timeliness and understandability)

6.2.2 IFRS S2 *Climate-related Disclosures*

In addition to the general guidance on disclosing sustainability-related financial information required by IFRS S1, entities are also required to consider climate-related disclosures under IFRS S2. At various points in these standards, entities are directed to **avoid unnecessary duplication of effort** when attempting to implement **both standards** by adopting practices that provide an **efficient solution** to the requirements of both standards.

Objective

The objective of IFRS S2 is is to require an entity to disclose information about its climate-related risks and opportunities that is useful to primary users of general purpose financial reports in making decisions relating to providing resources to the entity. This Standard requires an entity to disclose information about climate-related risks and opportunities that could reasonably be expected to affect the entity's cash flows, its access to finance or cost of capital over the short, medium or long term (IFRS S2: para.1-2).

Scope

The scope of IFRS S2 requires a **definition** of climate-related risks and opportunities. **Opportunities** refer to "…potentially positive climate-change generated outcomes for an entity…"

Climate-related risks refer to the "…potential negative effects of climate change on an entity…" and can be considered from different perspectives:

- **Physical risks**, which consist of:
  - **Event-driven** or **acute risks** arising from specific events such as a drought, flood and fire which can mean an entity is more prone to damage from such risks; and
  - **Longer-term** or **chronic risks** driven by more permanent shifts in the climate, such as rising sea- levels, which can affect the longer-term financial position and performance of an entity as it attempts to adapt to such risks
- **Transition risks** which arise when an entity attempts to **adapt** to participating in a lower-carbon economy – this may require policy, legal, technology or market changes in order to be able to facilitate this adaptation and may lead to financial or reputational risks emerging (IFRS S2: Appendix A).

Governance

Disclosures should inform users of the financial statements about the various governance controls in place to **monitor** and **manage** climate-related risks and opportunities. Examples of these should include:

- The individual or body with **overall responsibility** for climate-related risks and opportunities within the entity and how their **terms of reference** support this responsibility.
- **Policies and procedures** relating to the individual or body regarding their **skills**, **competence** and how they are **informed** in order to support this responsibility.
- How those responsible for managing climate-related risks and opportunities also consider the entity's **strategy**, **targets** and the **involvement of management** (IFRS S2: paras.5-7).

Strategy

Disclosures need to inform users of the financial statements about the entity's strategy for dealing with significant climate-related risks and opportunities. IFRS S2 provides further details on what strategy disclosures an entity should consider:

- Relevant significant climate-related risks and opportunities that could **influence** the entity's strategy and business model, as well as its financial performance, position and prospects.
- These significant climate-related risks and opportunities are expected to be presented within **industry-specific disclosure topics** (for example, those that are relevant to apparel, accessories & footwear, oil & gas services and medical equipment & supplies).
- The effects of significant climate-related risks and opportunities on the entity's **value chain**, **decision-making** and any **transition plans** it may have.
- The **resilience** of the entity's strategy to significant climate-specific risks (both physical and transition) including the results of any climate-related **scenario analysis** used to evaluate this resilience (IFRS S2: paras.8-9; Appendix B).

Risk management

Users of financial statements need to be able to understand how the entity **identifies**, **assesses** and **manages climate-related risks and opportunities** including the **maturity** of the **processes used** to assist with this evaluation (IFRS S2: para.B10). The standard requires disclosure of these risk management processes, including an assessment of **likelihood and impact**, methods of **prioritisation** and the use of **data** and other **assumptions** as part of the process (IFRS S2: para 25).

Metrics and targets

As with IFRS S1, an entity is expected to disclose **how** it uses metrics and targets to manage its significant climate-related risks and opportunities, including an assessment of the way it determines what **progress** it has made towards its chosen targets (IFRS S2: paras.27-28).

The disclosures are expected to include both **industry-specific metrics** and those that are **generic across all industries** – the generic metrics include the following:

- **Greenhouse gas emissions** across all activities and the entity's internal carbon price (such as the price per tonne of greenhouse gas emissions).
- The **proportion** of the entity's assets or activities that relate to both **transition** and **physical** climate- related risks and climate-related opportunities.
- The amount of **capital deployed** and **executive remuneration** linked to climate-related risks and opportunities (IFRS S2: para.29).

Targets are expected to be **justified** in terms of how **progress** against them can be **reported**, whether they are **absolute targets** (eg, an airline may propose a 5% reduction in CO2 emissions by a specific year) or **intensity targets** (eg, the airline may instead specify a 5% reduction in the amount of CO2 emissions per mile travelled by a specific year) plus relevant **timescales**, **milestones** and **starting positions** as well as how they **compare** with any international agreements currently in force. The entity should also disclose whether they have obtained any **third party assurance** on their target information (IFRS S2: para.33).

Appendices

The standard also contains appendices with definitions, industry-based disclosure requirements and the effective date of the proposed new standard.

6.3 Insurance

The IASB project to develop a comprehensive framework for insurance contracts culminated in the publication of IFRS 17, *Insurance Contracts* in 2017. IFRS 17 introduces a comprehensive reporting framework for insurance contracts that is intended to result in insurance companies producing financial statements which are more comparable, consistent and transparent. IFRS 17 is covered as a current issue in later chapters.

6.4 Disclosure initiative

6.4.1 Overview

The IASB's disclosure initiative is a broad-based undertaking exploring how disclosures in IFRS financial reporting can be improved. It is made up of a number of projects, the third of which, a Practice Statement on materiality was completed in September 2017.

6.4.2 Current status

Three projects, the amendments to IAS 1 and IAS 7, and a Practice Statement on materiality, are complete. The remainder are at the ED stage or the research stage.

6.5 Practice Statement on materiality

The IASB issued Practice Statement 2: *Making Materiality Judgements* in 2017. This is a tool to aid management in using judgement to decide what information is material and what is not; it is a non- mandatory document and does not have the status of an IFRS.

6.5.1 General characteristics of materiality

The Statement refers to the definition of materiality contained within the 2010 *Conceptual Framework:*

> "Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report."

(*Conceptual Framework for Financial Reporting,* para QC11)

Materiality is pervasive to the preparation of financial statements and affects recognition, measurement, presentation and disclosure.

When considering whether information is material, a company should consider its own circumstances and the needs of primary users of its financial statements ie, investors, lenders and other creditors.

6.5.2 Interaction with local laws and regulations

The Practice Statement clarifies that a company's financial statements must comply with requirements of IFRS, including those relating to materiality.

Providing additional information to meet local legal or regulatory requirements is allowed by IFRS, even if that information is not material, provided that it does not obscure material information.

6.5.3 Making materiality judgements

The Practice Statement includes a four-step process that entities may find useful in making materiality judgements:

Step 1 Identify information that has the potential to be material. This step requires consideration of IFRS requirements and the common information needs of primary users.

Step 2 Assess whether the information identified is material. Both quantitative and qualitative factors should be considered.

Step 3 Organise the information within the draft financial statements so that it supports clear and concise communication.

Step 4 Review the information provided as a whole, considering whether it is material individually and in combination with other information. At this stage information may need to be added or removed.

Identify information that has the potential to be material. This step requires consideration of IFRS requirements and the common information needs of primary users.

Assess whether the information identified is material. Both quantitative and qualitative factors should be considered.

Organise the information within the draft financial statements so that it supports clear and concise communication.

Review the information provided as a whole, considering whether it is material individually and in combination with other information. At this stage information may need to be added or removed.

6.5.4 Specific topics

Specific guidance is provided on how to make materiality judgements on prior period information, errors, covenants and in interim reporting.

6.6 Pointing forward to the future: approach to current issues

Current issues, as indicated above, are dealt with within the context of the topics. For a useful overview of what is to come, below is an extract from the IASB Work Plan, as at October 2022.

Project	Next milestone	Expected date
Business Combinations under Common Control	Decide Project Direction	
Cash Received via Electronic Transfer as Settlement for a Financial Assets(IFRS 9)	Decide Project Direction	
Climate-related Disclosure	IFRS Sustainability Disclosure Standard	
Contractual Cash Flow Characteristics of Financial Assets (Amendments to IFRS 9)	Exposure Draft	
Disclosure Initiative–Subsidiaries without Public Accountability: Disclosures	IFRS Accounting Standard	
Disclosure Initiative–Targeted Standards-level Review of Disclosures (IAS 1, 19, IFRS 13)	Decide project direction	October 2022
Dynamic Risk Management	Exposure Draft	
Equity Method	Decide project direction	
Extractive Activities	Decide project direction	H1 2023
Financial Instruments with Characteristics of Equity	Exposure Draft	
General Sustainability-related Disclosures	IFRS Sustainability Disclosure Standard	
Goodwill and Impairment	Decide Project Direction	November 2022
IFRS Accounting Taxonomy Update - Amendments to IAS 1 and IFRS 16	Proposed IFRS Taxonomy Update	November 2022
IFRS Sustainability Disclosure Taxonomy	Feedback on Staff Request for Feedback	November 2022
IFRS Accounting Taxonomy Update - 2022 General Improvements and	Proposed IFRS Taxonomy Update	
Common Practice		
Demand Deposits with Restrictions on Use (IAS 7)	Tentative Agenda Decision Feedback	Q1 2022
ISSB Consultation on Agenda Priorities		
Lack of Exchangeability (Amendments to IAS 21)	Decide Project Direction	
Lessor Forgiveness of Lease Payments (IFRS 9 and IFRS 16)	Agenda Decision	
Management Commentary	Decide Project	

Project	Next milestone	Expected date
	Direction	
Multi-currency Groups of Insurance Contracts (IFRS 17 and IAS 21)		
Non-current Liabilities with Covenants (Amendments to IAS 1)		
Post-implementation Review of IFRS 15 Revenue from Contracts with Customers		
Post-implementation Review of IFRS 9- Classification and Measurement	Feedback Statement	December 2022
Post-implementation Review of IFRS 9- Impairment	Request for Information	H1 2023
Primary Financial Statements	IFRS Accounting Standard	
Provisions - Targeted Improvements (Conceptual Framework, IAS 37, IFRIC 21)	Decide Project Direction	
Rate-regulated Activities	IFRS Accounting Standard	
Second Comprehensive Review of the IFRS for SMEs Standard	Exposure Draft Feedback	H1 2023
Post-implementation Review of IFRS 9– Classification and Measurement	Request for Information Feedback	H1 2022
Primary Financial Statements	IFRS Standard	-
Provisions–Targeted Improvements	Decide Project Direction	-
Special Purpose Acquisition Companies (SPAC): Accounting for Warrants at Acquisition	Agenda Decision	
Supplier Finance Arrangements	Decide Project Direction	November 2022

(Source: www. ifrs.org/projects/work-plan/)

Other potential current issues

Other topical issues which do not yet have their own specific IFRS include:

Effects of a natural disaster

The financial effects of a natural disaster, such as an earthquake or a hurricane, or indeed a pandemic such as the coronavirus pandemic, should be reflected in the financial statements of entities that are affected. Potential IFRS that could apply include:

(a) IAS 10, *Events After the Reporting Period*. If the event occurs after the year end, it will be non- adjusting. If the event spans the year end date, it may not always be straightforward to determine whether the event is adjusting or non-adjusting. Going concern may also be an issue.

(b) Compensation, clean-up costs and onerous contracts (IAS 37).

(c) Impairment of assets, including intangibles (IAS 36).

Digital assets. These include digital photos, music, film and documents, as well as digital currency, also known as **cryptocurrency.**

There are no accounting standards that specifically deal with cryptocurrencies.

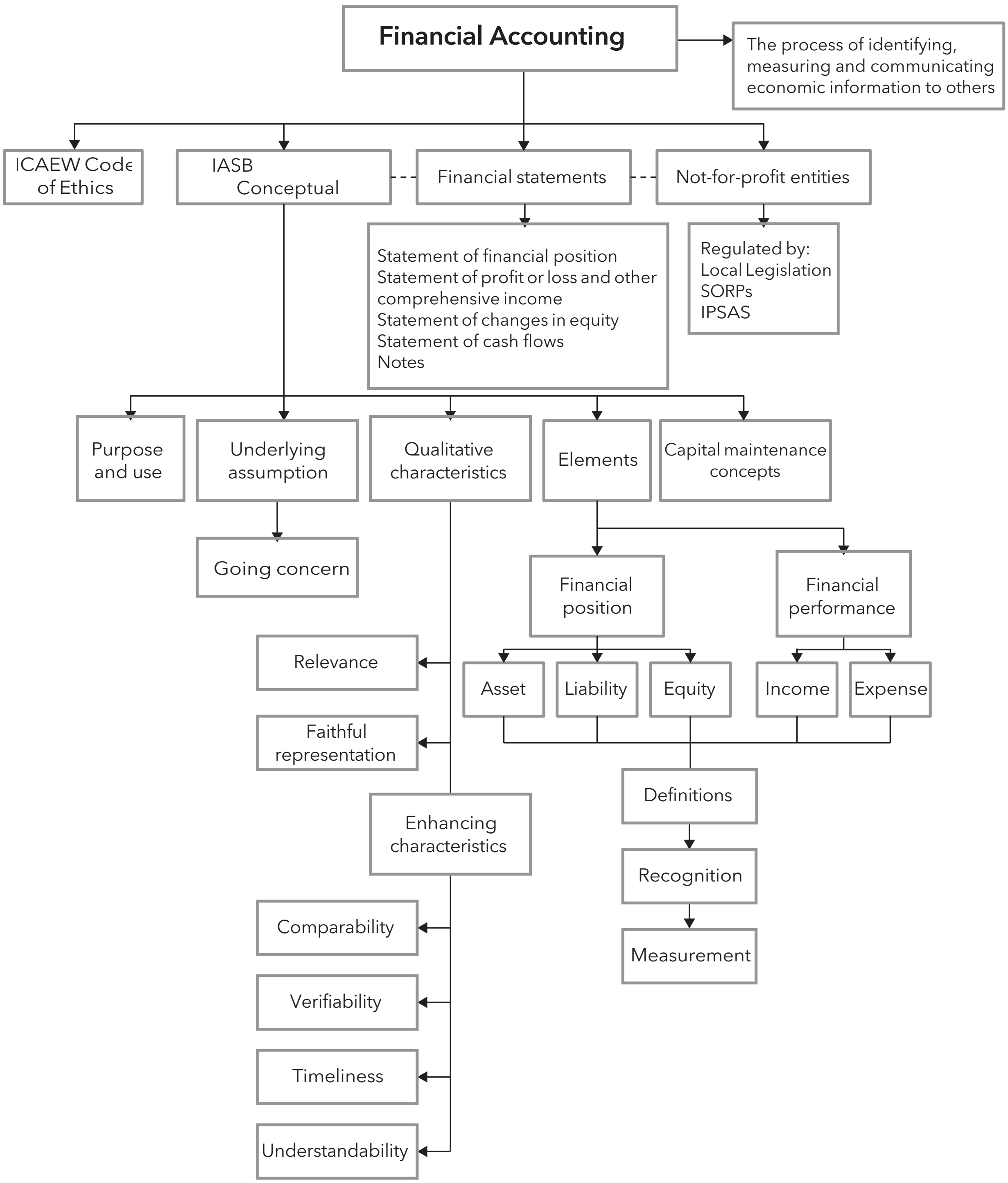
In developing the policy, IAS 8 *Accounting Policies, Accounting Estimates and Errors* requires that the directors consider the following hierarchy:

(a) IFRS Standards dealing with similar issues

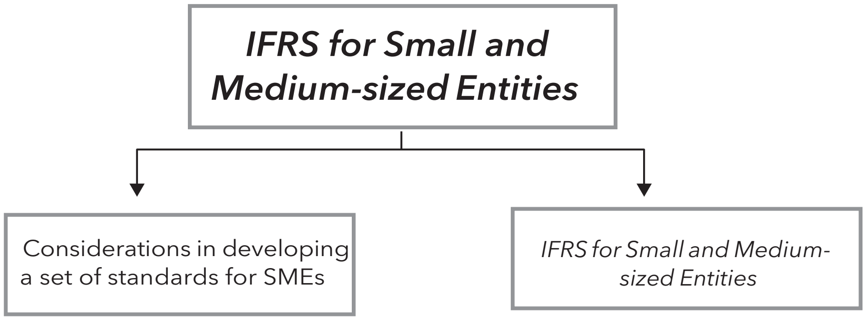
(b) The *Conceptual Framework*

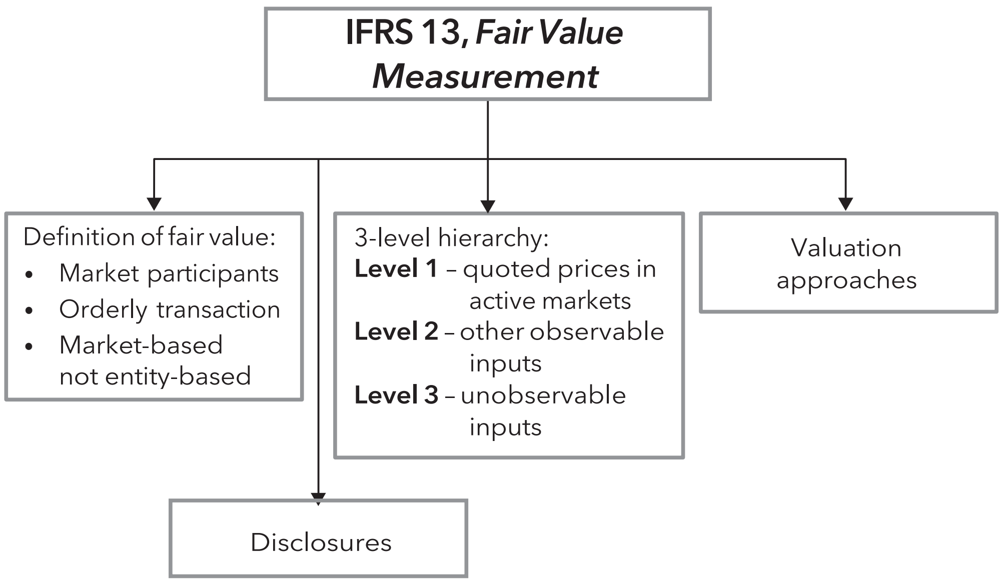
(c) The most recent pronouncements of other national GAAPs based on a similar conceptual framework and accepted industry practice

Summary



CHAPTER 2


IFRS for Small and Medium-sized Entities
Considerations in developing a set of standards for SMEs
IFRS for Small and Medium-sized Entities


IFRS 13, *Fair Value Measurement*
Definition of fair value:
• Market participants
• Orderly transaction
• Market-based not entity-based
3-level hierarchy:
Level 1 – quoted prices in active markets
Level 2 – other observable inputs
Level 3 – unobservable inputs
Valuation approaches
Disclosures

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Can you list the two fundamental and four enhancing qualitative characteristics of financial information? (Topic 1)
2.	How does the Conceptual Framework define a liability? (Topic 2)
3.	How should goodwill be accounted for under the IFRS for SMEs? (Topic 3)
4.	Have you understood what IFRS 13 means by the principal market? (Topic 4)
5.	Can you define and explain materiality? (Topic 5)
6.	What is the most recent IFRS? (Topic 6)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	**Learning benefit from attempting this question**
IASB *Conceptual Framework*	This short, straightforward question is included because this is the first time the revised *Conceptual Framework* has been tested.
IFRS 13, *Fair Value Measurement*	Fair value comes up so often in Corporate Reporting questions that it is important to do this comprehensive question to get a firm grasp of it at this early stage.
Polson	This is a full question covering most aspects of IAS 8 that you are likely to encounter.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted the self-test questions, you can continue your studies by moving onto the next chapter. In later chapters, we will recommend questions from the Question Bank for you to attempt.

Technical reference

The whole of the *Conceptual Framework for Financial Reporting* and *Preface to International Financial Reporting Standards* is examinable. The paragraphs listed below are the key references you should be familiar with.

1 What is financial reporting?

- Financial reporting is the provision of financial information about a reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity – **Conceptual Framework for Financial Reporting (Concept Frame) (1.2)**
- Financial statements comprise statement of financial position, statement of profit or loss and other comprehensive income, statement of changes in equity, statement of cash flows and notes – **IAS 1 (10**)

2 Purpose and use of financial statements

- Users' core need is for information for making economic decisions – **Concept Frame (1.2)**
- Objective is to provide information on financial position (the entity's economic resources and the claims against it) and about transactions and other events that change those resources and claims – **Concept Frame (1.4)**
- Financial position: – **Concept Frame (1.4**)
- Resources and claims
- Help identify entity's strengths and weaknesses
- Liquidity and solvency
- Changes in economic resources and claims: – **Concept Frame (1.18)**
- Help assess prospects for future cash flows
- How well have management made efficient and effective use of the resources
- Financial performance reflected by accrual accounting – **Concept Frame (1.17**)
- Financial performance reflected by past cash flows – **Concept Frame (1.21)**

3 Qualitative characteristics of useful financial information

- Two fundamental qualitative characteristics are relevance and faithful representation – **Concept Frame (2.5)**
- Relevance = capable of making a difference to decisions – **Concept Frame (2.6**)
- Predictive and confirmatory values – **Concept Frame (2.7)**
- Materiality – **Concept Frame (2.11)**
- Faithful representation – **Concept Frame (2.12**)
- Complete, neutral and free from error
- Four enhancing qualitative characteristics – **Concept Frame (2.25-2.34)**
- Comparability, verifiability, timeliness and understandability

4 Cost constraint on useful financial reporting

- Costs of (preparing and analysing) financial information must be justified by the benefits of reporting it – **Concept Frame (2.39-2.41)**

5 Reporting entity

- Underlying assumption: going concern – **Concept Frame (3.9)**
- Reporting period – **Concept Frame (3.4 - 3.7)**
- Perspective: entity as a whole, not a group of users – **Concept Frame (3.4 - 3.7)**
- Consolidated versus unconsolidated – **Concept Frame (3.15 - 3.17)**

6 Elements of financial statements

- **Asset:** A present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits – **Concept Frame (4.3, 4.4**)
- **Liability:** A present obligation of the entity to transfer an economic resource as a result of past events **– Concept Frame (4.26)**
- **Equity:** The residual interest in assets less liabilities; that is, net assets – **Concept Frame (4.63)**
- **Income** (comprising revenue and gains): Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims – **Concept Frame (4.68)**
- **Expenses** (including losses): Decreases in assets, or increases in liabilities, that result in decreases in equity other than those relating to distributions to holders of equity claims – **Concept Frame (4.69)**

7 Recognition

- An asset or liability should be recognised if it will be both **relevant** and provide users of the financial statements with a **faithful representation** of the transactions of that entity – **Concept Frame (4.38)**

8 Derecognition

Derecognition occurs (**Concept Frame (4.38)**) when:

- The entity loses control of all or part of the recognised asset; or
- The entity no longer has an obligation for a liability

9 Measurement

- Historical cost – **Concept Frame (6.17)**
- Current value
  - Fair value
  - Value in use
  - Current cost

10 Presentation and disclosure

- Focuses on principles not rules
- Classify by grouping similar items
- Aggregate to avoid unnecessary detail (**Concept Frame (7.2)**

11 Capital maintenance

- Financial capital: – **Concept Frame (4.57)**
- Monetary
- Constant purchasing power
- Physical capital

12 IASB

- Objectives of IASB – **Preface (6)**
- Scope and authority of IFRS – **Preface (7–16)**
- Due process re IFRS development – **Preface (17)**

13 IFRS for SMEs

- There are many considerations as to whether the same or a different set of IFRS Standards should apply to SMEs. The IFRS for SMEs applies to companies without public accountability (rather than using a size test).
- The IFRS for SMEs retains the core principles of 'full' IFRS, but reduces choice of accounting treatments and introduces a number of simplifications to reduce the reporting burden on SMEs.

14 IFRS 13, *Fair Value Measurement*

- Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date – **IFRS 13.9**
- Market-based measure – **IFRS 13.2**
- Three-level hierarchy – **IFRS 13.72**

15 IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*

16 Accounting policies IAS 8.7–13

17 Change in accounting policies

- Retrospective application is applying a new accounting policy as if that policy had always been applied
- If impracticable to determine the period-specific effects, apply prospectively

18 Changes in accounting estimates IAS 8.32–40

19 Prior period errors IAS 8.5, IAS 8.42 and IAS 8.49

20 Sustainability

IFRS Foundation (2021) *About the International Sustainability Standards Board*. [Online] Available at: https://www.ifrs.org/groups/international-sustainability-standards-board/ [Accessed 23 June 2022]

ISSB (2022) IFRS S1: IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information*. [Online] Available at: https://www.ifrs.org/content/dam/ifrs/project/general- sustainability-related-disclosures/exposure-draft-ifrs-s1-general-requirements-for-disclosure-of-sustai nability-related-financial-information.pdf [Accessed 21 June 2022]

ISSB (2022) IFRS S1: Basis for Conclusions on IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information*. [Online] Available at: https://www.ifrs.org/content/dam/ifrs/project/general-sustainability-related-disclosures/basis-for- conclusions-exposure-draft-ifrs-s1-general-requirements-for-disclosure-of-sustainability-related-finan cial-information.pdf [Accessed 21 June 2022]

ISSB (2022) IFRS S1: Illustrative Guidance on IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information*. [Online] Available at: https://www.ifrs.org/content/dam/ifrs/project/general-sustainability-related-disclosures/illustrative- guidance-exposure-draft-ifrs-s1-general-requirements-for-disclosure-of-sustainability-related-financia l-information.pdf [Accessed 21 June 2022]

ISSB (2022) IFRS S2: IFRS S2 *Climate-related disclosures*. [Online] Available at: https://www.ifrs.org/content/dam/ifrs/project/climate-related-disclosures/issb-exposure-draft-2022- 2-climate-related-disclosures.pdf [Accessed 21 June 2022]

ISSB (2022) IFRS S2: Basis for Conclusions on IFRS S2 *Climate-related disclosures*. [Online] Available at: https://www.ifrs.org/content/dam/ifrs/project/climate-related-disclosures/issb-exposure-draft-2022-2-basis-for-conclusions-climate-related-disclosures.pdf [Accessed 21 June 2022]

ISSB (2022) IFRS S2: Illustrative Guidance on IFRS S2 *Climate-related disclosures*. [Online] Available at: https://www.ifrs.org/content/dam/ifrs/project/climate-related-disclosures/issb-exposure-draft-2022-2-illustrative-guidance-on-climate-related-disclosures.pdf [Accessed 21 June 2022]

UN (2021) *Academic impact: Sustainability* [Online]. Available at: https://www.un.org/en/academic- impact/sustainability [Accessed 23 June 2022]

Self-test questions

Answer the following questions.

1 IASB Conceptual Framework

1.1 What are the conditions which the *Conceptual Framework* identifies as necessary if the going concern basis is to be used for the preparation of financial statements?

1.2 According to the *Conceptual Framework,* what are the characteristics of information which is **faithfully represented**?

2 IFRS for Small and Medium-sized Enterprises – Smerk

Smerk is a private pharmaceuticals company that meets the definition of an SME under national legislation and wishes to comply with the IFRS for Small and Medium-sized Entities for the year ended 31 December 20X6 (with one year of comparative data). The directors are seeking advice on how to address the following accounting issues. The entity currently prepares its financial statements under full IFRS.

(1) Smerk has significant amounts of capitalised development expenditure in its financial statements, £3.2 million at 31 December 20X5 (£2.8 million at 31 December 20X4), relating to investigation of new pharmaceutical products. The amount has continued to rise during the current year even after the amortisation commenced relating to some products that began commercial production.

(2) Smerk purchased a controlling interest (60%) of the shares of a quoted company in a similar line of business, Rock, on 1 July 20X6. Smerk paid £7.7 million to acquire the investment in Rock and the fair value of Rock's identifiable assets and liabilities has been calculated as £9.5 million at the date of acquisition. The value on the stock market of the non-controlling interests that Smerk did not purchase was £4.9 million. The directors do not feel in a position to estimate reliably the useful life of the goodwill due to the nature of the business acquired.

(3) Smerk purchased some properties for £1.7 million on 1 January 20X6 and designated them as investment properties under the cost model. No depreciation was charged, as a real estate agent valued the properties at £1.9 million at the year end.

Requirement

Discuss how the above transactions should be dealt with in the financial statements of Smerk for the year ending 31 December 20X6, with reference to the *IFRS for SMEs*.

3 IFRS 13, Fair Value Measurement

Vitaleque, a public limited company, is reviewing the fair valuation of certain assets and liabilities in light of the introduction of IFRS 13, *Fair Value Measurement*.

It carries an asset that is traded in different markets and is uncertain as to which valuation to use. The asset has to be valued at fair value under International Financial Reporting Standards. Vitaleque currently only buys and sells the asset in the African market. The data relating to the asset are set out below.

Year to 30 November 20X2	North American market	European market	African market
Volume of market – units	4m	2m	1m
Price	£19	£16	£22
Costs of entering the market	£2	£2	£3
Transaction costs	£1	£2	£2

Additionally, Vitaleque had acquired an entity on 30 November 20X2 and is required to fair value a decommissioning liability. The entity has to decommission a mine at the end of its useful life, which is in three years' time. Vitaleque has determined that it will use a valuation technique to measure the fair value of the liability. If Vitaleque were allowed to transfer the liability to another market participant, then the following data would be used.

Input	Amount
Labour and material cost	£2m
Overhead	30% of labour and material cost
Third-party mark-up – industry average	20%
Annual inflation rate	5%
Risk adjustment – uncertainty relating to cash flows	6%
Risk-free rate of government bonds	4%
Entity's non-performance risk	2%

Vitaleque needs advice on how to fair value the liability.

Requirement

Discuss, with relevant computations, how Vitaleque should fair value the above asset and liability under IFRS 13

4 IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors

Statement of financial position extracts for the Kamao Company show the following.

	31 December 20X7	31 December 20X6
	£'000	£'000
Development costs	812	564
Amortisation	(180)	(120)
	632	444

The capitalised development costs related to a single project that commenced in 20X4. It has now been discovered that one of the criteria for capitalisation has never been met.

Requirement

According to IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, by what amount should retained earnings be adjusted to restate them as at 31 December 20X6?

5 Hookbill

The Hookbill Company was updating its inventory control system during 20X7 when it discovered that it had, in error, included £50,000 in inventories in its statement of financial position as at the year end 31 December 20X6 relating to items that had already been sold at that date. The 20X6 profit after tax shown in Hookbill's financial statements for the year to 31 December 20X6 was £400,000.

In the draft financial statements for the year to 31 December 20X7, before any adjustment for the above error, the profit after tax was £500,000.

Hookbill pays tax on profits at 25%.

Requirement

According to IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, what figures should be disclosed for profit after tax in the statement of profit or loss and other comprehensive income of Hookbill for the year ended 31 December 20X7, for both 20X7 and the comparative year 20X6?

6 Carduus

The Carduus Company manufactures motorboats. It has invested heavily in developing a new engine design. As a result, by 1 January 20X2 it had capitalised £72 million of development costs, which it was amortising over 10 years on a straight-line basis from that date.

Until 1 January 20X7, Carduus's new engine had been selling well and making substantial profits. However, a new competitor then entered the market, such that revised estimates were that the new engine would cease to generate any economic benefits after 31 December 20X9 and that the remaining amortisation period should be to this date on a straight-line basis. The entry of the new competitor led to an impairment review, but no impairment loss was identified.

Retained earnings at 31 December 20X6 were £400 million. Profit before tax and any amortisation charges was £70 million for the year ended 31 December 20X7

Requirement

Ignoring tax, determine the retained earnings figure for Carduus at 1 January 20X7 in the financial statements for the year to 31 December 20X7 and the profit before tax for the year then ended after adjusting for the change in amortisation according to IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors.*

7 Aspen

The Aspen Company was drawing up its draft financial statements for the year to 31 December 20X7 and was reviewing its cut-off procedures. It discovered that it had, in error, at the previous year end, omitted from inventories in its statement of financial position a purchase of inventories amounting to
£100,000 made on the afternoon of 31 December 20X6. The related purchase transaction and the trade payable had been correctly recorded.

The retained earnings of Aspen at 31 December 20X6 as shown in its 20X6 financial statements were
£4,000,000. In the draft financial statements for the year to 31 December 20X7, before any adjustment of the above error, the profit after tax was £800,000. Aspen pays tax on profits at 30%.

Requirement

According to IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, what figures should be disclosed in the financial statements of Aspen for the year ended 31 December 20X7 for profit after tax for the year and for retained earnings at 1 January 20X7?

8 Polson

The Polson Company appointed Rayner as finance director late in 20X7. One of Rayner's initial tasks was to ensure that a thorough review was carried out of Polson's accounting policies and their application in the preparation of Polson's consolidated financial statements for the year ended 31 December 20X6. This review identified the following issues in relation to the 20X6 consolidated financial statements which were approved for publication early in 20X7.

(1) The £840,000 year-end carrying amount of a major item of plant in a wholly-owned subsidiary comprised costs incurred up to 31 December 20X6. Depreciation was charged from 1 January 20X7 when the item was for the first time working at normal capacity. The depreciation charge takes account of residual value of £50,000 on 30 September 20Y4, the end of the item's useful life. The overall construction and installation of the item was completed on 30 September 20X6, when the item was first in full working order. Between 1 October and 31 December 20X6 the item was running below normal capacity as employees learnt how to operate it. The year-end carrying amount comprises: costs incurred to 30 September 20X6 of £800,000 plus costs incurred in October to December 20X6 of £50,000 less £10,000 sales proceeds of the output sold in October to December.

(2) On 1 January 20X6 Polson acquired a 30% interest in The Niflumic Company for £240,000, which it classified in its consolidated financial statements as an investment in equity instruments under IFRS 9, *Financial Instruments*. Polson has representation on Niflumic's board of directors. Niflumic's shares are dealt in on a public market and the year-end carrying amount of £360,000 was derived using the market price quoted on that date. The fair value increase of £90,000 (£360,000 – £240,000 less 25% deferred tax) was recognised in an available-for-sale reserve in equity. In its year ended 31 December 20X6 Niflumic earned a post-tax profit of £80,000 and paid no dividends.

(3) At 31 December 20X6 the total trade receivables in a 60% owned subsidiary was £360,000 according to the accounting records, while the separate list of customers' balances totalled £430,000. The accounting records were adjusted by adding the difference to both the carrying amount of trade receivables and revenue. It was revealed that the difference arose from double- counting certain customers' balances when taking the list out.

The 20X6 consolidated financial statements showed £400,000 as the carrying amount of retained earnings at the year end. The effect of taxation is immaterial in respect of the item of plant and the trade receivables adjustment.

Requirement

Determine the following amounts for inclusion as comparative figures in Polson's 20X7 consolidated financial statements after the adjustments required by IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*.

(1) The carrying amount of the item of plant at 31 December 20X6

(2) The increase/decrease in equity at 31 December 20X6 in respect of the investment in Niflumic

(3) The carrying amount of retained earnings at 31 December 20X6

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

Question	Answer
Oak plc has purchased a patent for £40,000. The patent gives the company sole use of a particular manufacturing process which will save £6,000 a year for the next five years.	This is an asset, albeit an intangible one. There is a past event, control and future economic benefit (through cost saving).
Elm plc paid John Brown £20,000 to set up a car repair shop, on condition that priority treatment is given to cars from the company's fleet.	This cannot be classed as an asset. Elm plc has no control over the car repair shop and it is difficult to argue that there are future economic benefits.
Sycamore plc provides a warranty with every washing machine sold.	This is a liability. The business has an obligation to fulfil the terms of the warranty. The liability would be recognised when the warranty is issued rather than when a claim is made.

Answer to Interactive question 2

Statement of profit or loss and other comprehensive income for 20X7 (extract)

	20X6	20X7
	£'000	£'000
Sales	47,400	67,200
Cost of goods sold (W1)	(38,770)	(51,600)
Profit before tax	8,630	15,600
Income tax (W2)	(2,620)	(4,660)
Profit for the year	6,010	10,940
Retained earnings Opening retained earnings		
As previously reported		
	13,000	21,950
Correction of prior period error (4,200 – 1,260)		(2,940)
As restated	13,000	19,010
Profit for the year	6,010	10,940
Closing retained earnings	19,010	29,950

WORKINGS

(1) **Cost of goods sold**

	20X6	**20X7**
	£'000	**£'000**
As stated in question	34,570	55,800
Inventory adjustment	4,200	(4,200)
	3,770	51,600

(2) **Income Tax**

	20X6	**20X7**
	£'000	**£'000**
As stated in question	3,880	3,400
Inventory adjustment (4,200 × 30%)	(1,260)	1,260
	2,620	4,660

Answers to Self-test questions

1 IASB Conceptual Framework

1.1 Neither the intention nor the need to liquidate or curtail materially the scale of its operations.

1.2 It should be complete, neutral and free from error.

2 IFRS for Small and Medium-sized Enterprises – Smerk

Discussion as follows:

(1) **Development expenditure**

The *IFRS for SMEs* requires small and medium-sized entities to expense all internal research and development costs as incurred unless they form part of the cost of another asset that meets the recognition criteria in the IFRS. The adjustment on transition to the *IFRS for SMEs* must be made at the beginning of the comparative period (1 January 20X5) as a prior period adjustment. Thus the expenditure of £2.8 million on research and development should all be written off directly to retained earnings. Any amounts incurred during 20X5 and 20X6 must be expensed in those years' financial statements and any amortisation charged to profit or loss in those years will need to be eliminated.

(2) **Acquisition of Rock**

The *IFRS for SMEs* requires goodwill to be recognised as an asset at its cost, being the excess of the cost of the business combination over the **acquirer's interest** in the net fair value of the identifiable assets, liabilities and contingent liabilities. Non-controlling interests at the date of acquisition must therefore be measured at the proportionate share of the fair value of the identifiable assets and liabilities of the subsidiary acquired (ie, the 'partial' goodwill method).

After initial recognition the acquirer is required to amortise goodwill over its useful life under the *IFRS for SMEs*. If an entity is unable to make a reliable estimate of the useful life of goodwill, the life is presumed to be 10 years.

Goodwill will be calculated as:

	£m
Consideration transferred	7.7
Non-controlling interests (at % FVNA: 9.5 × 40%)	3.8
Fair value of identifiable net assets at acquisition	(9.5)
	2.0
Amortisation (2.0/10 years × 6/12)	(0.1)
	1.9

The amortisation of £0.1 million must be charged to profit or loss in 20X6.

(3) **Investment properties**

Investment properties must be held at fair value through profit or loss under the IFRS for SMEs where their fair value can be measured without undue cost or effort, which appears to be the case here, given that an estate agent valuation is available. Consequently a gain of £0.2 million (£1.9m – £1.7m) will be reported in Smerk's profit or loss for the year.

3 IFRS 13, Fair Value Measurement

Discussion as follows:

(1) **Fair value of asset**

Year to 30 November 20X2	**North American market**	**European market**	**African market**
Volume of market – units	4m	2m	1m
	£	**£**	**£**
Price	19	16	22
Costs of entering the market	(2)	(2)	n/a
Potential fair value	17	14	22
Transaction costs	(1)	(2)	(2)
Net profit	16	12	20

Additional information

- Because Vitaleque currently buys and sells the asset in the African market, the costs of entering that market are not incurred and therefore not relevant.
- Fair value is not adjusted for transaction costs. Under IFRS 13, these are not a feature of the asset or liability, but may be taken into account when determining the most advantageous market.
- The North American market is the principal market for the asset because it is the market with the greatest volume and level of activity for the asset. If information about the North American market is available and Vitaleque can access the market, then Vitaleque should base its fair value on this market. Based on the North American market, the fair value of the asset would be £17, measured as the price that would be received in that market (£19) less costs of entering the market (£2) and ignoring transaction costs.
- If information about the North American market is not available, or if Vitaleque cannot access the market, Vitaleque must measure the fair value of the asset using the price in the most advantageous market. The most advantageous market is the market that maximises the amount that would be received to sell the asset, after taking into account both transaction costs and usually also costs of entry; that is, the net amount that would be received in the respective markets. The most advantageous market here is therefore the African market. As explained above, costs of entry are not relevant here, and so, based on this market, the fair value would be £22.
- It is assumed that market participants are independent of each other, knowledgeable, and able and willing to enter into transactions.

(2) **Fair value of decommissioning liability**

Because this is a business combination, Vitaleque must measure the liability at fair value in accordance with IFRS 13, rather than using the best estimate measurement required by IAS 37, Provisions, Contingent Liabilities and Contingent Assets. In most cases there will be no observable market to provide pricing information. If this is the case here, Vitaleque will use the expected present value technique to measure the fair value of the decommissioning liability. If Vitaleque were contractually committed to transfer its decommissioning liability to a market participant, it would conclude that a market participant would use the inputs as follows, arriving at a fair value of £3,215,000.

Input	**Amount**
	£'000
Labour and material cost	2,000
Overhead: 30% × 2,000	600
Third-party mark-up – industry average: 2,600 × 20%	520
	3,120
Inflation adjusted total (5% compounded over three years): 3,120 × 1.05^3	3,612
Risk adjustment – uncertainty relating to cash flows: 3,612 × 6%	217
	3,829
Discount at risk-free rate plus entity's non-performance risk: (4% + 2% = 6%): 3,829 ÷ 1.06	3,215

4 IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors

£444,000

Per IAS 8.42 a correction of a material error should be applied retrospectively by restating the opening balances of assets, liabilities and equity for the earliest prior period presented

5 Hookbill

20X7: £537,500

20X6: £362,500

	20X7	**20X6**
	£	**£**
Draft profit after tax	500,000	400,000
Inventory adjustment	50,000	(50,000)
Tax thereon at 25%	(12,500)	12,500
Revised profit after tax	537,500	362,500

The comparative amounts for the prior period should be restated, per IAS 8.42.

Correction of opening inventory will increase profit for the current period, by the amount of the after- tax adjustment. Conversely, the closing inventory for the previous period is reduced, thereby reducing profit by the after-tax effect of the adjustment.

6 Carduus

Retained earnings: £400m Profit before tax: £58.0m

The change in useful life is a change in an accounting estimate which is accounted for prospectively (IAS 8.36). So retained earnings brought forward remain unchanged, at £400 million.

The carrying amount of development costs at 1 January 20X7 (halfway through their previously estimated useful life) is (£72m × 5/10) £36 million. Writing this off over three years gives a charge of £12 million per annum. So the profit before tax is £70m – £12m = £58m.

7 Aspen

Profit after tax: £730,000 Retained earnings: £4,070,000

The comparative amounts for the prior period should be restated, per IAS 8.42.

The correction of opening inventories will decrease profit for the current period, by the after-tax value of the adjustment. Thus current period profits are £800,000 – (£100,000 × 70%) = £730,000.

The closing inventories of the previous period are increased by the same amount. So retained earnings are £4,000,000 + (£100,000 × 70%) = £4,070,000.

8 Polson

Figures as follows:

(1) £776,562

(2) (£66,000)

(3) £318,562

All these matters give rise to prior period errors which require retrospective restatement of financial statements as if the prior period error had never occurred (IAS 8.5).

(1) Recognition of cost in the carrying amount of PPE should cease when it is in the condition capable of being operated in the manner intended, so on 30 September 20X6, and depreciation should begin on the same date (IAS 16.20 and 55). So gross cost should be adjusted to £800,000 (£840,000 – £50,000 + £10,000) and depreciation, taking into account overall useful life and residual value, charged for 3 months, so £23,438 ((£800,000 – £50,000) × 1/8 × 25%). The restated carrying amount is £776,562 (£800,000 – £23,438).

(2) The investment in The Niflumic Company is an associate and should be accounted for according to IAS 28, not IFRS 9.

The value of the investment will therefore increase by 30% of Niflumic's post-tax profit rather than according to fair values.

	£
Amount recognised in other components of equity	90,000
30% × Niflumic's profit after tax (retained earnings)	24,000
Adjustment to equity	(66,000)

(3)

	£
Draft retained earnings	400,000
Reduction in carrying value of plant (£840,000 – £776,562)	(63,438)
Niflumic's earnings (£80,000 × 30%)	24,000
Error in trade receivables (£70,000 × 60%)	(42,000)
	318,562

Trade receivables, revenue and therefore profit were overstated by £70,000 in respect of the trade receivables. Polson's share is 60%, so end-20X6 retained earnings must be reduced by £42,000.

The share of Niflumic's profits is recognised in retained earnings, not in a separate reserve, giving rise to an increase of £24,000.

Chapter 3

Ethics

Introduction

Learning outcomes

- Identify and explain ethical issues in reporting, assurance and business scenarios
- Explain and appraise the relevance, importance and consequences of ethical issues
- Evaluate the impact of ethics on a reporting entity, relating to the actions of stakeholders
- Recommend and justify appropriate actions where ethical and professional conduct issues arise in a given scenario
- Design and evaluate appropriate safeguards to mitigate threats and provide resolutions to ethical problems

Specific syllabus references for this chapter are: 19(a)–(e)

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	**The importance of ethics** This first section reminds you of how important it is to do the right thing in the workplace and beyond.	**Approach** This should remind you of why you continue to study ethics – use it to maintain your focus. **Stop and think** WorldCom occurred at the very start of the 20th Century – do you think there is still a risk of good companies doing bad things?	Every question you attempt will need to consider the public interest so always consider how actions look through the lens of various ethical codes.	**IQ1: Ethics and the individual** Use this as an opportunity to remind yourself of how a professional accountant should behave in the face of such adversity.
2	**Ethical codes and standards** The way that you should act is always under consideration – note how these codes have evolved to keep up with current developments.	**Approach** Each of these codes of ethics is contained within your open book permitted text. **Stop and think** Make sure you understand the contents of each of these codes and standards – are you up to date with recent changes?	As you found at the Professional Level, being able to navigate around the open book permitted text under time pressure is very important, so learn to do this whenever you attempt questions.	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive questions
3	**Ethics: financial reporting focus** This section will remind you how ethics applies to the accountant in business.	**Approach** The fundamental principles, threats and safeguards should all be revision for you. **Stop and think** The remaining sections all relate to the work of creating financial information, so while you study them, consider how they could occur in real life.	You should be on the lookout for any clues from the scenario that suggest some questionable ethical behaviour is occurring. For example, considering the FIFA worked example, is there any evidence of bribery or corruption?	N/A
4	**Ethics: audit and assurance focus** This section will remind you how ethics applies to the accountant in practice. Note the recent developments to address ongoing issues from the profession.	**Approach** Having read about the current versions of the IESBA and ICABCodes, you need to make sure that you can find everything you need in the open book permitted text. **Stop and think** Do you know how to respond if presented with a variety of different ethical threats?	Responding appropriately to ethical threats is dependent upon being able to identify and diagnose these threats in the first place, so your technique should always start by confirming the problem and then evaluating suitable alternatives in response.	**IQ2: Ethical risks** Use this as a recap of all the ethical threats that an auditor is likely to face. **IQ3: Stewart Brice** Once you have studied this section, attempt this question to see how well you are able to apply this knowledge.
5	**Making ethical judgements** Not every scenario will be straightforward to diagnose and may require a systematic approach to determine the right response.	**Approach** Work your way methodically through the resolution process. **Stop and think** You may find it helpful to consider a real world problem that you are familiar with when working through the resolution process.	As explained in 'Exam context' you should be prepared for more complex situations when attempting questions in the Corporate Reporting exam.	**IQ4: Revenue recognition** This is a brilliant way of demonstrating how financial reporting and auditing knowledge can be blended together to provide an ethical challenge. How will you respond to this?
6	**Money laundering regulations** The threat of money laundering is going nowhere so you must always keep up to date with current	**Approach** Much of this is revision but you should make sure there is nothing new here from the last time you studied the subject.	The biggest challenge with money laundering is being able to identify it so always be on the lookout for tell-tale signs of questionable	N/A

CHAPTER 3

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	developments in this area.	**Stop and think** Can you explain how the Bangladesh government is currently dealing with money laundering?	financial activity.	
7	**Integrity, objectivity and independence** To supplement your knowledge of the open book permitted text, here are some examples of how the Code of Ethics can be applied.	**Approach** Work through this with the open book permitted text in front of you. **Stop and think** Can you find where each of the threats is covered?	Use this as an opportunity to consider how the various threats could be examined.	N/A
8	**Provisions available for small entities** The Ethical Standard covers issues where the guidance is relaxed for smaller entities.	**Approach** Work through this with the open book permitted text in front of you. **Stop and think** Can you find where each of the key points is covered?	Use this as an opportunity to consider how these points could be examined.	N/A

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 The importance of ethics

Section overview

- Ethical behaviour is essential to maintain public confidence.
- Guidance is provided in professional codes of conduct and ethical standards.

1.1 Introduction

In general terms, ethics is a set of **moral principles** and **standards of correct behaviour**. Far from being noble ideals which have little impact on real life, they are essential for any society to operate and function effectively. Put simply, they help to differentiate between right and wrong, although their application often involves **complex issues, judgement and decisions**. While ethical principles can be incorporated into law, in many cases their application has to depend on the self-discipline of the individual. This principle can be seen to apply to society as a whole, the business community and the accounting profession.

1.2 Ethics in business

Business life is a fruitful source of ethical dilemmas because its whole purpose is material gain, the making of profit. Success in business requires a constant search for potential advantage over others and businesspeople are under pressure to do whatever yields such an advantage. As a result, organisations have become increasingly under pressure to act, and **to be seen to be acting, ethically**. In recent years, many have demonstrated this by publishing **ethical codes**, setting out their values and responsibilities towards stakeholders.

In some instances, businesses may be forced to adopt a more ethical approach. In 2013, in some developed economies, many bank chief executives saw a pay cut for the first time in years. This was partly due to tightened regulations which now require banks to align executive pay more closely to risks and performance. Arguably more forceful, however, are the investor revolts arising as a result of shareholders' anger at rising pay in a time of falling profits and reduced dividend payouts.

The ongoing developments in **sustainability** also mean that businesses now need to consider not only acting in an ethical manner but also in a sustainable manner as well – is it possible to satisfy both? The desire to be seen to be acting in the public interest may mean an entity faces an **impossible dilemma** – take the scenario of a **government considering its energy policy** and whether to generate electricity by continuing with mature industries reliant on fossil fuels such as oil and coal or replace them with renewable sources of energy such as wind and solar instead.

- Discontinuing fossil fuels will have serious implications for the industries that rely on them, affecting jobs and communities, and requiring significant transition costs
- Retaining fossil fuels will lead to the inevitable failure to comply with the Paris Accord and for that country to achieve net zero

While this is a simplistic view of a very complex problem, it does illustrate the dilemmas faced by those seeking to walk the line between ethics and sustainability.

Context example: When sportswashing and greenwashing collide

There are plenty of examples of greenwashing (exaggerating your sustainability credentials to improve your reputation) and its near relative sportswashing (associating with a popular sport to improve your reputation) but can this happen at the same time?

Let's start with **sportswashing**. Take a look around at high-profile sports teams and events – how many of them are associated with controversial owners or investors? Here are some examples:

- The 2022 Winter Olympics held in Beijing re-ignited the debate about the treatment of certain ethnic groups in China
- The football World Cups of 2018 and 2022 were both haunted by ongoing concerns over human rights issues with the host nations Russia and Qatar respectively
- Football has also seen unprecedented levels of investment from nation states with questionable human rights records, for example Saudi Arabia with its ownership of Newcastle United Football Club and the recruitment of several high-profile stars to play in the Saudi league, plus hosting a number of high-profile events including the 2034 FIFA men's World Cup
- Hosting a Grand Prix in Bahrain has been considered by some to be a way of drawing attention away from the country's poor human rights record
- During 2023, the threat posed by the breakaway Saudi-backed LIV golf tour was averted as the sport's major bodies all agreed to co-operate within a Saudi-funded merger

Undoubtedly, all of these relate to globally recognised sports where big money is at stake but there is an argument each is attempting to legitimise the actions of the investor (although the rise in popularity of sport and tourism in the Middle East has simply been described as a way of these economies diversifying away from their core industries to address the need to transition away from their traditional dependency on oil).

What about **greenwashing**? Commonly cited examples of this could include recycling advice on products that are inherently unsustainable (such as plastic drinks bottles) or misleading claims about lower emissions (such as those from airlines and their marketing) that cannot be substantiated. Is sport being used in a similar way? The money for a lot of sporting investment is arguably down to the unsustainable wealth of oil-producing nations who are undoubtedly benefiting from their links to these high-profile and attractive events and activities.

Either way, the threat of being associated with both greenwashing and sportswashing presents risks for sport overall - is it a good move in the long term to be associated with something that affects its reputation and at the same time should be diminishing in its influence or does it suggest that the world is still a long way from embracing sustainability issues and that carbon-based products are here to stay for the foreseeable future?

1.3 Ethics and the accounting profession

The IESBA *Code of Ethics for Professional Accountants* (IESBA Code) states:

"A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the **public interest**."

The public interest is considered to be the collective well-being of the community of people and institutions the professional accountant serves. These include the following:

- Clients
- Lenders
- Governments
- Employers
- Employees
- Investors
- The business and financial community
- Others who rely on the work of the professional accountant

For the work of the accountant in practice or in business to maintain its value, the accountant must be respected and trusted. The individual professional accountant therefore has a **duty** and a **responsibility** to maintain the **reputation** of the profession and the **confidence of the public**.

1.4 Ethics and the individual

While legislation and professional bodies have their part to play through issuing guidance, the importance of the **integrity of the individual** cannot be overestimated. Its ethical consequences are potentially very significant in deciding, for example, whether to whistleblow on questionable practice at work, despite pressure from colleagues or superiors or negative consequences of doing so.

The devastating effect of the ethical choices of one individual can be seen in the following summary of the role played by Betty Vinson, an accountant at WorldCom.

Context example: WorldCom

WorldCom, the US long-distance telephone carrier, is 'credited' with being responsible for a fraud that created the largest bankruptcy in US history. This reportedly resulted in a fine of $500 million, which at the time was the largest fine ever imposed by the Securities and Exchange Commission (SEC).

The problems began for WorldCom in mid-2000. Its operating costs were increasing sharply due to the fees which it had to pay to other companies for use of their telephone networks. Its chief executive officer and chief financial officer had had to inform Wall Street of lower than expected profits for the second half of the year and there was increasing pressure to improve results. Betty Vinson was working for WorldCom at this time as a senior manager in the corporate accounting division. She was asked by her boss to falsify the accounts in order to increase profits. This was achieved primarily by capitalising line costs rather than treating them as operating expenses. While Betty Vinson considered resignation due to the pressure she was put under to falsify the results, she continued to work for WorldCom until early 2002 and was promoted from senior manager to director with an increase in salary of $30,000. Over an 18-month period she had helped to falsify records at the request of her bosses, increasing profits by $3.7 billion.

By March 2002 questions were being asked by internal audit. Vinson decided to disclose the details of the falsified records to the FBI, the SEC and the US Attorney. She had hoped that her testimony could be exchanged for immunity from prosecution; however, this was not the case. In October 2002 she pleaded guilty to two counts of conspiracy and securities fraud (carrying a maximum sentence of 15 years) and in October 2003 she was charged with entering false information on company documents (carrying a maximum sentence of 10 years).

Interactive question 1: Ethics and the individual

1.1 From the Context Example above, list the factors which you think may have affected Betty Vinson's decision to make the fraudulent entries.

1.2 What other courses of action could she have taken? See **Answer** at the end of this chapter.

Professional skills focus: Applying judgement

Sometimes doing the right thing is not straightforward and you should be prepared to consider things in a personal capacity.

One of the other courses of action that Betty Vinson could have taken would have been to **blow the whistle** – expose the fraud she was asked to participate in either within or outside the organisation. Admittedly, as the highest levels of management were involved in the WorldCom case, making an internal disclosure would have fallen on deaf ears at best, or at worst caused Betty Vinson to lose her job. However, Betty Vinson could have considered making an external disclosure: to the professional regulatory body of which she was a member, to public regulators, or, perhaps as a last resort, to the media. A timely disclosure could have brought the fraudulent activities to an end, mitigating their disastrous consequences.

In the UK, the Public Interest Disclosure Act 1998 (PIDA 1998) aims to protect whistleblowers who raise genuine concerns about malpractice in organisations, including the following:

- Crimes
- Civil offences (including negligence, breach of contract and breach of administrative law)
- Miscarriages of justice
- Dangers to health and safety and/or the environment
- Attempts to cover up any of the above

The Act overrides the confidentiality clauses which may be contained in employment contracts, and provides recourse to the employment tribunal should the whistleblower be victimised.

The text of PIDA 1998, as well as useful examples of whistleblowing cases, can be found on the website of the charity Protect: www.pcaw.org.uk

2 Ethical codes and standards

Section overview

- The accounting profession has developed principles-based codes, including the IESBA Code and the ICAEW Code of Ethics.
- The ICAEW Code centres around five fundamental principles and a professional accountant is responsible for recognising and assessing potential threats to these fundamental principles.
- Where threats are identified, a professional accountant must then implement safeguards to eliminate these threats or reduce them to an acceptable level.

2.1 IESBA, ICAB and FRC Codes

As a key aspect of reputation and professionalism is ethical behaviour, the accounting profession has developed **ethical codes of conduct**. These include:

- The IESBA Code of Ethics for Professional Accountants (IESBA Code). The Bangladesh FRC adopted the International Code of Ethics for Professional Accountants including the International Independence Standards. Previously the IESBA Code was adopted by the ICAB.
- The ICAB Code of Conduct (Schedule C).

The IESBA Code provides ethical guidance internationally for IFAC members. The ICAB Code contains additional guidance or requirements. Therefore, compliance with Bangladesh FRC Code and ICAB Code will will ensure compliance with the IESBA Code. The Bangladesh FRC Code and ICAB Code will be referred to the Codes for the purpose of the Chapter.

You should be familiar with the Code from your previous studies, although it is possible the material you covered at the Professional Level may not have been based on the most up to date versions. This section summarises the key points.

The ICAB Code is compliance based. The ICAB Code covers the following topics:

- Professional misconduct in relation to Chartered Accounts in Practice (Schedule C, Part I)
- Professional misconduct in relation to members of the Institute in service (Schedule C, Part II)
- Professional misconduct in relation to management consultancy
- Professional and other misconduct

The Bangladesh FRC Code (I,e,. IESBA Code) is **principles-based** and members are responsible for:

- identifying threats to compliance with the fundamental principles;
- evaluating the significance of these threats; and
- implementing safeguards to eliminate them or reduce them to an acceptable level.

The guidance in the Code is given in the form of:

- fundamental principles; and
- illustrations as to how they are to be applied in specific situations.

The Code applies to all members, students, affiliates, employees of member firms and, where applicable, member firms, in all their professional and business activities, whether remunerated or voluntary.

It is important to note therefore that adhering to the Code is equally important for a member working in business as it is for a member working in practice, even though the ethical codes are sometimes perceived to be associated more with the accountant in practice.

ICAB and FRC W are committed to enforcing the Code through disciplining members who do not meet reasonable ethical and professional expectations of the public and other members.

A copy of the ICAB Code is included in the Member's Handbook and is available at www.icab.orb.bd. The Bangladesh FRC Code is available at https://frc.gov.bd/.

CHAPTER 3

3 Ethics: financial reporting focus

Section overview

- This section provides a summary of some key points covered in the ethics learning material in the Financial Accounting and Reporting paper at Professional Level.
- Here we primarily consider the application of the ICAB and Bangladesh FRC Code (the "Codes") to the **accountant in business** involved in a financial reporting environment (we look at the accountant in practice in section 4).

3.1 Fundamental principles

Professional accountants are expected to follow the guidance contained in the fundamental principles in the IESBA Code in all their professional and business activities. The professional accountant should also follow the requirements in the illustrations. However, they should be guided not just by the terms but also by **the spirit of the Code**.

The Code sets out five fundamental principles, the spirit of which must always be complied with.

(a) Integrity

A professional accountant should be straightforward and honest in all professional and business relationships.

A professional accountant should not be associated with reports, returns, communications or other information where they believe that the information:

- contains a materially false or misleading statement;
- contains statements or information provided recklessly; or
- omits or obscures required information where such omission or obscurity would be misleading.

(b) Objectivity

A professional accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgements.

(c) Professional competence and due care

A professional accountant has an obligation to:

- attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organisation receives competent professional services based on current technical and professional standards and relevant legislation; and
- act diligently and in accordance with applicable technical and professional standards.

Professional competence may be divided into two separate phases:

- Attainment of professional competence – initial professional development
- Maintenance of professional competence – continuing professional development (CPD)

Diligence encompasses the responsibility to act in accordance with the requirements of an assignment, carefully, thoroughly and on a timely basis.

(d) Confidentiality

A professional accountant should:

- respect the confidentiality of information acquired as a result of professional and business relationships;
- be alert to the risk that confidential information may be inadvertently disclosed;
- not disclose any such information to third parties without proper and specific authority (unless there is a legal or professional duty to disclose); and
- not use such information for the personal advantage of themselves or third parties.

The professional accountant must maintain confidentiality even in a social environment and even after employment with the client/employer has ended.

A professional accountant may be required to disclose confidential information:

- where there is a professional duty or right to disclose, when not prohibited by law, for example:
  - complying with the quality review of a professional body
  - responding to a professional or regulatory body inquiry or investigation
  - protecting a professional accountant's professional interests in legal proceedings
  - complying with technical and professional standards, including ethical requirements
- where disclosure is permitted by law and is authorised by the client or employer;

- where disclosure is required by law, for example:
  - production of documents or other provision of evidence in the course of legal proceedings
  - disclosure to the appropriate public authorities of infringements of the law that come to light; and
  - in cases where disclosure may be in the public interest (recent developments on non- compliance with laws and regulations (NOCLAR) in a later section are relevant here).

(e) Professional behaviour

A professional accountant should comply with relevant laws and regulations and should avoid any action that discredits the profession.

In marketing and promoting themselves professional accountants should not bring the profession into disrepute. That is, they should not make:

- Exaggerated claims for the services they are able to offer, the qualifications they possess or experience they have gained; or
- disparaging references or unsubstantiated comparisons to the work of others.

3.2 Threats

Compliance with these fundamental principles may potentially be threatened by a broad range of circumstances. Many of these threats can be categorised as follows:

(a) Self-interest threat

The threat that a financial or other interest of a professional accountant or of an immediate or close family member will inappropriately influence the professional accountant's judgement or behaviour.

Examples of circumstances that may create such threats include the following:

- Financial interests, loans or guarantees
- Incentive compensation arrangements
- Inappropriate personal use of corporate assets
- Concern over employment security
- Commercial pressure from outside the employing organisation

(b) Self-review threat

The threat that a professional accountant will not appropriately evaluate the results of a previous judgement made by the professional accountant.

(c) Advocacy threat

The threat that a professional accountant will promote a client's or employer's position to the point that the professional accountant's objectivity is compromised.

(d) Familiarity threat

The threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work.

Examples of circumstances that may create such threats include:

- a professional accountant in business, who is in a position to influence financial or non-financial reporting or business decisions, where an immediate or close family member would benefit from that influence;
- long association with business contacts influencing business decisions; and
- Acceptance of a gift or preferential treatment, unless the value is clearly insignificant.

(e) Intimidation threat

The threat that a professional accountant will be deterred from acting objectively by threats, either actual or perceived.

Examples of circumstances that may create such threats include the following:

- Threat of dismissal or replacement in business, of yourself, or of a close or immediate family member, over a disagreement about the application of an accounting principle or the way in which financial information is to be reported
- A dominant personality attempting to influence the decision-making process, for example with regard to the awarding of contracts or the application of an accounting principle.

Professional skills focus: Structuring problems and solutions

Having good knowledge of all the fundamental principles and threats to objectivity at your disposal will help you to understand how best to identify a suitable response to an ethical issue once you can suitably identify what the problem really is!

3.3 Safeguards

There are two broad categories of safeguards which may eliminate or reduce such threats to an acceptable level:

Safeguards created by the profession, legislation or regulation

Examples are:

- Educational, training and experience requirements for entry into the profession
- CPD requirements
- Corporate governance regulations
- Professional standards
- Professional or regulatory monitoring and disciplinary procedures
- External review by a legally empowered third party of reports, returns, communication or information produced by a professional accountant
- Effective, well-publicised complaints systems operated by the employing organisation, the profession or a regulator, which enable colleagues, employers and members of the public to draw attention to unprofessional or unethical behaviour
- An explicitly stated duty to report breaches of ethical requirements

Safeguards in the work environment

Examples are:

- The employing organisation's systems of corporate oversight or other oversight structures
- The employing organisation's ethics and conduct programmes
- Recruitment procedures in the employing organisation emphasising the importance of employing high calibre, competent staff
- Strong internal controls
- Appropriate disciplinary processes
- Leadership that stresses the importance of ethical behaviour and the expectation that employees will act in an ethical manner
- Policies and procedures to implement and monitor the quality of employee performance

- Timely communication to all employees of the employing organisation's policies and procedures, including any changes made to them, and appropriate training and education given on such policies and procedures
- Policies and procedures to empower and encourage employees to communicate to senior levels within the employing organisation any ethical issues that concern them without fear of retribution
- Consultation with another appropriate professional accountant

3.4 Ethical conflict resolution

When evaluating compliance with the fundamental principles, a professional accountant may be required to resolve a conflict in complying with the fundamental principles.

A professional accountant may face pressure to:

- act contrary to law or regulation;
- act contrary to technical or professional standards;
- facilitate unethical or illegal earnings management strategies;
- lie to, or otherwise mislead, others; in particular:
  - the auditor of the employing organisation, and
  - regulators; or
- issue, or otherwise be associated with, a financial or non-financial report that materially misrepresents the facts, for example:
  - financial statements,
  - tax compliance,
  - legal compliance, and
  - reports required by securities regulators.

3.5 Preparation and reporting of information

Accountants will often be involved in the preparation and reporting of information that may be:

- made public; or
- used by others inside or outside the employing organisation.

The accountant should:

- prepare or present such information fairly, honestly and in accordance with relevant professional standards;
- present financial statements in accordance with applicable financial reporting standards; or
- Maintain information for which they are responsible in a manner which:
  - describes clearly the true nature of the business transactions, assets or liabilities;
  - classifies and records information in a timely and proper manner; and
  - represents the facts accurately and completely in all material respects.

3.6 Acting with sufficient expertise

An accountant should only undertake significant tasks for which they have, or can obtain, sufficient specific training or expertise.

Circumstances that threaten the ability of the accountant to perform duties with the appropriate degree of professional competence and due care include:

- insufficient time for properly performing or completing the relevant duties;
- incomplete, restricted or otherwise inadequate information for performing the duties properly;
- insufficient experience, training and/or education; and
- inadequate resources for the proper performance of the duties.

Safeguards that may be considered include:

- obtaining additional advice or training;
- ensuring that there is adequate time available for performing the relevant duties;
- obtaining assistance from someone with the necessary expertise; and
- consulting where appropriate with:
  - superiors within the employing organisation,
  - independent experts; or
  - ICAEW.

3.7 Financial interests

An accountant may have financial interests, or may know of financial interests of immediate or close family members, that could in certain circumstances threaten compliance with the fundamental principles.

Examples of circumstances that may create self-interest threats are if the accountant or family member:

- Holds a direct or indirect financial interest in the employing organisation and the value of that interest could be directly affected by decisions made by the accountant.
- Is eligible for a profit-related bonus and the value of that bonus could be directly affected by a decision made by the accountant
- Holds, directly or indirectly, share options in the employing organisation, the value of which could be directly affected by decisions made by the accountant
- Holds, directly or indirectly, share options in the employing organisation which are, or will soon be, eligible for conversion
- May qualify for share options in the employing organisation or performance-related bonuses if certain targets are achieved

Safeguards against such threats may include the following:

- Policies and procedures for a committee independent of management to determine the level or form of remuneration of senior management
- Disclosure of all relevant interests and of any plans to trade in relevant shares to those charged with the governance of the employing organisation, in accordance with any internal policies
- Consultation, where appropriate, with superiors within the employing organisation
- Consultation, where appropriate, with those charged with the governance of the employing organisation or relevant professional bodies
- Internal and external audit procedures
- Up to date education on ethical issues and the legal restrictions and other regulations around potential insider trading

3.8 Inducements

An accountant, or their immediate or close family, may be offered an inducement such as:

- gifts;
- hospitality;
- preferential treatment; or
- inappropriate appeals to friendship or loyalty.

An accountant should assess the risk associated with all such offers and consider whether the following actions should be taken:

- Immediately inform higher levels of management or those charged with governance of the employing organisation.
- Inform third parties of the offer, for example a professional body or the employer of the individual who made the offer, or seek legal advice.
- Advise immediate or close family members of relevant threats and safeguards where they are potentially in positions that might result in offers of inducements (for example as a result of their employment situation).
- Inform higher levels of management or those charged with governance of the employing organisation where immediate or close family members are employed by competitors or potential suppliers of that organisation.

Context example: FIFA

The 2018 football World Cup in Russia was widely regarded as a success both on and off the field, due to the engagement of fans with their Russian hosts and the quality of the football viewed by audiences across the world. Yet only three years earlier, the organising body of the World Cup, FIFA, was being investigated for widespread corruption among many of its most senior officials.

Like any high-profile sporting administrator, FIFA has always attracted criticism, but the decision- making processes for awarding both the 2018 and 2022 tournaments came under intense scrutiny following accusations of bribery and corruption among those responsible for deciding on host countries. After an internal investigation, FIFA concluded that the bidding process was fair, although it did not release its report to the public in full, leading to the resignation of the investigation's independent author in protest.

The accusations continued until 2015, when criminal investigations were launched by the US and Swiss authorities which eventually led the leadership structure to remove a number of long-standing 'big' personalities including overall FIFA president Sepp Blatter and his European counterpart Michel Platini: both men were banned from football for eight years by FIFA's ethics committee, although these were subsequently reduced on appeal.

Although the US investigation in 2015 centred on bribes to senior officials of around US$2 million, sums thought to be in excess of US$150 million have also been mentioned in association with illegal payments to secure media and marketing rights to future tournaments. FIFA made more than US$2 billion from the 2014 World Cup tournament held in Brazil. In November 2020, Blatter and Platini were prosecuted by the Swiss authorities who alleged an illegal payment had been made by Blatter to Platini of 2m Swiss francs (around £1.6 million) but in July 2022, the pair were found not guilty after the court accepted the money related to the legitimate supply of advisory services.

The leadership of FIFA continues to face a massive task in restoring faith in the transparency of its own governance arrangements and the public perception of football and its engagement on the global stage.

(Source: BBC News (21 December 2015) FIFA corruption crisis: Key questions answered. [Online]. Available from: www.bbc.co.uk/news/world-europe-32897066 [Accessed 27 May 2022]

BBC News (8 July 2022) Sepp Blatter and Michel Platini found not guilty following fraud trial. [Online]. Available from: www.bbc.co.uk/sport/football/62081675 [Accessed 8 July 2022])

3.9 Conflicts of interest

An accountant should take reasonable steps to identify circumstances that could pose a conflict of interest.

Examples might be:

- an accountant in public practice, competing directly with a client, or having a joint venture or similar arrangement with a major competitor of a client;
- an accountant performing services for clients whose interests are in conflict; or
- clients are in dispute with each other in relation to the matter or transaction in question.

Safeguards should include:

- notifying the client of the firm's business interest or activities that may represent a conflict of interest, and obtaining their consent to act in such circumstances;
- notifying all known relevant parties that the professional accountant is acting for two or more parties in respect of a matter where their respective interests are in conflict and obtaining their consent to so act; and
- Notifying the client that the accountant does not act exclusively for any one client in the provision of proposed services and obtaining their consent to so act.

3.10 General duty to report

Under the ICAB's Bye-laws it is the duty of every member where it is in the public interest to do so, to report to the Institute any facts or matters indicating that a member and/or firm or provisional member may have become liable to disciplinary action. In determining whether it is in the public interest to report such facts or matters, regard shall be had to such guidance as the Council shall give from time to time.

3.11 Practical significance

Accountants working within a financial reporting environment can come under pressure to improve the financial performance or financial position of their employer. Finance managers who are part of the team putting together the results for publication must be careful to withstand pressures from their non-finance colleagues to indulge in reporting practices which dress up short-term performance and position. Financial managers must be conscious of their professional obligations and seek appropriate assistance from colleagues, peers or independent sources.

Visit icaew.com (https://www.icaew.com/-/media/corporate/files/technical/ethics/ethical-case-studies/ccabeg-case-studies-accountants-public-practice.ashx?la=en) to access 'Ethical Dilemmas Case Studies' covering ethical dilemmas that are relevant to accountants – including a set of case studies specific to accountants in practice.

3.12 Promoting the role and mindset expected of professional accountants

You will no doubt have seen and heard plenty of comments about inadequate levels of professional scepticism being displayed by audit and assurance providers when undertaking engagements.
Given the significance of this alongside the need to address the expectation gap and other perceived ethical shortcomings across the whole of the profession, in 2019 the IESBA decided to consider whether the use of professional scepticism should be extended to apply to all professional accountants.

After a consultation period, IESBA concluded that while professional scepticism was fundamentally important to preserve trust in the profession, the term felt more appropriate to the nature of audit and assurance work, and there were other characteristics that professional accountants should display in order to be viewed as acting with something like professional scepticism. These were discussed in terms of the role and mindset expected of professional accountants and are summarised below.

- The importance of the role played by professional accountants as part of society and their duty to act in the public interest
- Enhancements to the descriptions of objectivity and professional behaviour within the IESBA Code of Ethics
- Reinforcing the importance of acting with integrity in difficult circumstances when there are easier options that could be taken
- Consideration of the impact of technology on the work of the professional accountant, ensuring competence is maintained and an awareness of the threat of bias from using certain datasets (see below)
- Keeping an open mind about anything that a professional accountant could be faced with as part of their work (as this covers issues such as challenging the views held by others and reserving judgement until all relevant information is available, it is perhaps the closest thing to professional scepticism contained in these proposals)
- An awareness of how cultural factors within an organisation and certain types of bias can affect the judgement of a professional accountant

The IESBA code has been redrafted to contain amendments that reflect these proposals. One of the areas that professional accountants should be aware of is the section on any bias that could create threats to being able to apply the conceptual framework. A brief summary of examples of such bias is shown below.

- Anchoring bias, where judgements are based on an initial piece of information that subsequently turns out to be inaccurate or unrepresentative, leading you to draw inappropriate conclusions
- Automation bias, where machine-generated data is considered superior to human-generated data despite evidence to the contrary
- Availability bias, where easily available information is favoured ahead of information which is less easy to access
- Confirmation bias, where you are inclined to trust information that supports something you already think you know, as opposed to challenging the status quo if such evidence exists
- Groupthink, which is sticking to the views of the group as opposed to considering innovative or individual solutions
- Overconfidence bias, where you assume you possess more expertise about an issue than is justified
- Representation bias, where conclusions about a population are drawn based on factors that may not be representative enough
- Selective perception, where conclusions are drawn based upon what you expect to see instead of keeping an open mind

With this last point, we are back again at professional scepticism – it is clearly a very fine line between the expectations that relate to professional accountants and those that apply to audit and assurance practitioners, but you should still be aware of the key points raised here when considering the mindset expected of a professional accountant.

4 Ethics: audit and assurance focus

Section overview

- This section focuses on ethical guidance most relevant to accountants in practice providing assurance services and builds on the material covered in the Assurance paper at Certificate Level and the Audit and Assurance paper at Professional Level.
- It also provides detail of recent changes to the relevant ethical codes and standards:
  - IESBA Code
  - ICAB Code
  - Revised Ethical Standard

Interactive question 2: Ethical risks

From your knowledge brought forward from your previous studies, and any practical experience of auditing you may have, write down as many potential ethical risk areas concerning audit as you can in the areas below. (Some issues may be relevant in more than one column.)

Personal interests	Review of your own work	Disputes	Intimidation

See **Answer** at the end of this chapter.

4.1 Development of the 2018 IESBA Code

4.1.1 Content changes

One of the driving forces behind the update to the IESBA Code was the conclusion of the **NOCLAR** (non-compliance with laws and regulations) project.

This project addressed professional accountants' responsibilities when they become aware of non- compliance or suspected non-compliance with laws and regulations committed by a client or employer. The IESBA Code states that the objectives of the professional accountant are as follows:

- To comply with the principles of integrity and professional behaviour
- By alerting management or, where appropriate, those charged with governance of the employing organisation, to seek to:
  - enable them to rectify, remediate or mitigate the consequences of the identified or suspected non-compliance; and
  - deter the commission of the non-compliance where it has not yet occurred.
- To take such further action as appropriate in the public interest (IESBA Code: para. 260.4)

Where the professional accountant becomes aware of information concerning instances of non- compliance or suspected non-compliance the following procedures are required. The professional accountant must:

- obtain an understanding of the matter;
- address the matter;
- determine whether further action is needed;
- consider any imminent breaches; and
- consider any additional documentation requirements.

(IESBA Code: para 260.12-23)

In January 2017, the IESBA issued a close off document: **Addressing the Long Association of Personnel with an Audit or Assurance Client**. This states that for audits of Public Interest Entities an individual cannot act as the engagement partner, the individual appointed as responsible for the engagement quality review or any other key audit partner role (or a combination of these roles) for a period of more than seven cumulative years (para R540.5). This period is known as the time-on period. After the time-on period, the individual shall serve a cooling-off period in accordance with paragraphs R540.11 to R540.19. :

- Engagement partner: five consecutive years
- Individual responsible for the engagement quality control review: three consecutive years
- Individual who has acted in any other capacity as key audit partner: two consecutive years

Note: This document was issued prior to the adoption of the quality management standards in 2021 when the terms **quality control** and **engagement quality control review** were still in use – however, in this instance you can assume that these practices are referring to what you understand to be **quality management** and **engagement quality reviews** respectively.

A previous close off document from 2016 provided guidance on two further areas which are now included in the 2018 IESBA Code: **Preparation and presentation of information** (section 220) and **Pressure to breach the fundamental principles** (section 270). While these are presented in the context of the professional accountant in business, the auditor should consider these expectations which have now been explicitly raised as part of their audit approach.

When **preparing or presenting information**, a professional accountant shall:

(a) Prepare or present information in accordance with a relevant reporting framework, where applicable;

(b) Prepare or present the information in a manner that is intended neither to mislead nor to influence contractual or regulatory outcomes inappropriately;

(c) Exercise professional judgement to:

    (1) Represent the facts accurately and completely in all material respects

    (2) Describe clearly the true nature of business transactions or activities; and

    (3) Classify and record information in a timely and proper manner

(d) Not omit anything with the intention of rendering the information misleading or of influencing contractual or regulatory outcomes inappropriately.

A professional accountant shall not allow pressure from others to result in a **breach of compliance with the fundamental principles** or place pressure on others that the accountant knows, or has reason to believe, would result in the other individuals breaching the fundamental principles. (IESBA Code: para R270.3)

4.1.2 Structural changes

In addition to the content changes mentioned above, the IESBA has changed the format and structure of the 2018 Code as follows:

- Guide to the code
- International Code of Ethics for Professional Accountants (including International Independence Standards)
- Preface
- Part 1 – Complying with the Code, fundamental principles and conceptual framework
- Part 2 – Professional accountants in business
- Part 3 – Professional accountants in public practice
- International independence standards: Part 4A Independence for audit and review engagements and 4B Independence for assurance engagements other than audit and review engagements
- Glossary, including list of abbreviations
- Effective dates (mostly 15 June 2019)

This restructured Code is now referred to as the International Code of Ethics for Professional Accountants (including International Independence Standards).

4.2 The IESBA Code 2023

The 2023 edition of the International Code of Ethics for Professional Accountants (including International Independence Standards) (the Code) was issued in September 2023 and incorporates:

(a) The revisions relating to (a) the definition of engagement team, and (b) group audits. The revisions deal with the independence and other implications of the changes made to the definition of "engagement team" in the Code to align with changes to the definition of the same term in the IAASB's International Standards on Auditing (ISAs) and International Standards on Quality Management (ISQMs). The revisions also address holistically the various independence considerations in an audit of group financial statements. The revised provisions relating to the definition of engagement team and group audits will be effective for audits of financial statements and audits of group financial statements for periods beginning on or after 15 December 2023. Early adoption of the revisions is encouraged.

(b) The revisions will become effective for audits of financial statements and audits of group financial statements for periods beginning on or after 15 December 2023.

(c) A signpost of the expiring "jurisdictional provision" addressing long association of personnel with an audit client. The jurisdictional provision will expire and be no longer available for audits of financial statements for periods beginning on or after 15 December 2023. Under the jurisdictional provision (paragraph R540.20 of the Code), where a legislative or regulatory body (or organization authorized or recognized by such legislative or regulatory body) has established a cooling-off period for an engagement partner of less than five consecutive years, that shorter cooling-off period may be applied, subject to a floor of three years, provided that the applicable time-on period does not exceed seven years.

(d) In addition, the 2023 edition of the Code contains the IESBA-approved revised definition of a public interest entity (and related provisions) and technology-related revisions that will become effective in December 2024.

Note: At the time of issuance of this workbook, the IESBA Code 2022 was published and made available in the FRC website. Hence this chapter is based on the IESBA Code 2022. However, this section has been incorporated to make the examinees aware of the key changes introduced in the IESBA Code 2023. The IESBA Code 2023 can be found at: https://www.ethicsboard.org/publications/2023-handbook-international-code-ethics-professional-accountants.

4.3 Threats and safeguards

The IESBA Code, the ICAB Code and the FRC Ethical Standard are all based on the principle that integrity, objectivity and independence are subject to various threats and that safeguards must be in place to counter these.

The majority of threats fall into the following categories:

Threat	Example
Self-interest threat	Undue dependence on total fees from a client
Self-review threat	Reporting on the operation of financial systems after being involved in their design or implementation
Management threat	Where the audit firm has been involved in the design, selection and implementation of financial information technology systems (This threat is included in the FRC Ethical Standard only)
Advocacy threat	Acting as an advocate on behalf of an assurance client in litigation or disputes with third parties
Familiarity or trust threat	A member of the engagement team having a close or immediate family relationship with a director of the client
Intimidation threat	Being threatened with dismissal or replacement in relation to a client engagement

(a) The B Code defines a **safeguard** to be '…actions, individually or in combination, that the professional accountant takes that effectively reduce threats to compliance with the fundamental principles to an acceptable level.'

(b) The Codes considers that there are two general categories of safeguards. These are safeguards created by the profession, legislation or regulations and safeguards in the work environment**.** Safeguards in the work environment may differ according to whether a professional accountant works in public practice, in business or in insolvency.

C H A P T E R 3

(c) When evaluating safeguards, the auditor should consider what a reasonable and informed third party, having knowledge of all relevant information, including the significance of the threat and the safeguards applied, would conclude to be unacceptable.

4.4 Professional appointment

The following procedures for **acceptance and continuance** are applicable based on the Codes. The prospective auditor should consider the various **threats** that an engagement could present – for example:

- integrity and professional behaviour issues may arise from clients with questionable integrity (these can be evaluated by considering the client's integrity and the existence of any suitable governance practices in place)
- self-interest threats could arise from undertaking work that the auditor is not competent to complete (a thorough understanding of the nature of the work being considered is therefore essential)

When considering a prospective engagement, the prospective auditor needs to determine if there are any **reasons** for not accepting the engagement (in other words, would it lead to a threat that could not be satisfactorily dealt with by safeguards).

A suitable response would be to undertake **research** of the prospective client (usually by some form of enquiry) or to ask for information about the prospective client from the existing auditor.

- The prospective auditor should explain to the prospective client that they have a professional duty to communicate with the existing auditor.
- The client should be requested to confirm the proposed change to the existing auditor and to authorise the existing auditor to co-operate with the prospective auditor.
- The prospective auditor should then consider whether to accept or decline the appointment in the light of the information received from the existing auditor
- The existing auditor is required to respond promptly to requests for information, however where enquiries are not answered the prospective auditor should write to the existing auditor by recorded delivery stating an intention to accept the appointment within a specified period of time.
- The prospective auditor is allowed to assume that silence implies that there are no adverse comments to be made. However, the fact that no reply was received should be considered as part of the overall decision-making process.

4.5 Access to information by successor auditors

Unlike the UK Companies Act 2006, in Bangladesh, currently the CA 1994 does not require the predecessor auditor to allow the successor auditor access to all relevant information in respect of its **audit work**. This includes access to relevant working papers.

However, some of the key points in ISAs are as follows:

Some of the key points in this guidance are:

- The request should be made after the successor has been formally appointed
- The successor should consider whether to make a request and the extent of that request
- The request should be as specific as possible. There are specific references to reviewing a predecessor's audit work in:
  - ISA 510 Initial Engagements – Opening Balances

- ISA 710 Comparative Information – Corresponding Figures And Comparative Financial Statements
- ISA 300 Planning an Audit of Financial Statements

- The predecessor should be prepared to assist the successor by providing oral or written explanations
- It is reasonable for the successor to make notes of its review
- There is no obligation to allow copying of papers, but it would be reasonable to allow copying of extracts of the books and records of the client, analyses of financial statement figures and documentation of the client's systems and processes
- Providing access to working papers in this way is not a breach of confidentiality because it is done in order to comply with auditing standards. (A letter from the predecessor to the successor should be copied to the client as a matter of courtesy.)

Interactive question 3: Stewart Brice

You are the Ethics Partner at Stewart Brice, a firm of chartered accountants. The following situations exist.

Teresa is the audit manager assigned to the audit of Recreate, a large quoted company. The audit has been ongoing for one week. Yesterday, Teresa's husband inherited 1,000 shares in Recreate. Teresa's husband wants to hold on to the shares as an investment.

The Stewart Brice pension scheme, which is administered by Friends Benevolent, an unconnected company, owns shares in Tadpole Group, a listed company with a number of subsidiaries. Stewart Brice has recently been invited to tender for the audit of one of the subsidiary companies, Kermit Co.

Stewart Brice has been the auditor of Kripps Bros, a limited liability company, for a number of years. It is a requirement of Kripps Bros' constitution that the auditor owns a token £1 share in the company.

Requirements

3.1 Comment on the ethical and other professional issues raised by the above matters.

3.2 Identify the ethical and professional issues Stewart Brice would need to consider.

See **Answer** at the end of this chapter.

5 Making ethical judgements

Section overview

- The application of ethical guidance requires skill and judgement and relies on the integrity of the individual.
- The Codes provide a framework for the resolution of ethical conflicts.
- In the exam, you will be expected to identify ethical issues and evaluate alternative courses of action.

5.1 Resolving ethical conflicts

Although there are a number of sources of ethical guidance, resolving ethical issues can be complex. As you have seen in your earlier studies, there are some specific rules which can be applied, but current UK ethical guidance is primarily **principles-based**.

The application of these principles requires a degree of skill and the onus is placed on the integrity and judgement of the individual in weighing up the facts of the situation. In addition, it may mean that in certain circumstances there is more than one acceptable outcome.

The Codes recognise that conflicts in the application of fundamental principles may need to be resolved. When providing a service the professional accountant must take into account:

- the **client's requirements**; and
- the **public interest**.

Where these are in conflict, **the public interest should take priority**.

The following help sheet, which was produced by the ICAEW (ICAEW, 2014), sets out a framework that accountants can follow when faced with these issues, which you may find useful when considering ethical problems in the exam.

The help sheet suggests that the resolution process should consider the following:

Relevant facts Do I have all the relevant facts? Am I making assumptions? Is it my problem or can anyone else help?	This may involve: • referring to the organisation's policy, procedures, code of conduct and previous history; or • discussing the matter with trusted managers and employees.
Relevant parties Who are the individuals, organisations and key stakeholders affected? How are they affected? Are there conflicts between different stakeholders? Who are your allies?	These may include those directly affected eg, shareholders, employees and employers but may also include the community at large.
Ethical issues involved Would these ethical issues affect the reputation of the accountancy profession? Would they affect the public interest?	These include: • professional ethical issues; • organisational ethical issues; and • personal ethical issues. You could refer to the ICAEW Code of Ethics for help.
Fundamental principles affected and any associated ethical threats Which fundamental principles are affected? Which threats to compliance exist? Are there safeguards in place which can reduce or eliminate the threats?	This will involve reference to the relevant ethical guidance from the IESBA Code: • Section 110 for the fundamental principles • Section 120.6 A3 for threats to these fundamental principles Are any of these threats clearly insignificant?

Established internal procedures Does your organisation have policies and procedures to deal with this situation? How can you escalate concerns within your organisation? Is there a whistleblowing procedure?	The professional accountant may find it useful to discuss ethical conflict issues with: • immediate superior; • the next level of management; • a corporate governance body; or • other departments eg, legal, audit, human resources.
Alternative courses of action Have all the consequences been discussed and evaluated? Will the proposed course of action stand the test of time? Would a similar course of action be undertaken in a similar situation? Would the course of action stand scrutiny from peers, family and friends?	The following should be considered: • The organisation's policies, procedures and guidelines • Applicable laws and regulations • Universal values and principles adopted by society • Consequences Whenever considering an ethical issue, thought processes, discussions and decisions should all be recorded and can be referred to if you need to justify your actions in future.

Where the conflict is significant and cannot be resolved, the accountant would need to **seek legal advice**. After exhausting all other possibilities and depending on the nature of the conflict, the individual may conclude that withdrawal from the engagement team or resignation from the firm/employing organisation is appropriate.

Note: Withdrawal/resignation would be seen very much as a last resort.

Professional skills focus: Structuring problems and solutions

Scenarios in the exam may be discrete and straightforward, but what if they are not? Use this systematic resolution process to help you work the problem logically.

5.2 Exam context

Ethical issues will have been examined in earlier papers. However, at the Advanced Level you will be faced with **more complex situations**. More emphasis will be placed on your ability to use your **judgement** in the light of the facts provided, rather than testing your knowledge of the ethical codes and standards in detail. In some instances, the correct action may be uncertain and it will be your ability to identify the **range of possible outcomes** which will be important rather than concluding on a single course of action.

You should also be aware that the term 'ethics' will be used in a much broader sense than it has been in the earlier Assurance and Audit and Assurance papers. It is likely to be combined with **financial reporting and business issues** where you may be required to assess the ethical judgements made by others, including management. You may also be asked to consider the issue from the point of view of the accountant in practice and the accountant in business.

The following Interactive question demonstrates these points.

Interactive question 4: Revenue recognition

You are the auditor of Bellevue Ltd for the year ended 31 December 20X8. The company provides information to the financial services sector and is run by the Managing Director, Toby

Stobbart. It has a venture capital investment of which part is in the form of a loan. The investment agreement details a covenant designed to protect the loan. This states an interest cover of two is required as a minimum ie, the company must be able to cover interest and loan principal repayments with profits at least twice.

70% of the revenue of the business is subscription based and contracts are typically three years in duration. 30% of the revenue is for consultancy work which is billed on completion of the work.
Consultancy projects are for a maximum of two months.

During the previous year the management performed a review of the subscription revenue and concluded that 40% of this represented consultancy work and should therefore be recognised in the first year of the contract rather than being recognised over the duration of the contract as had previously been the case. The audit file for 20X7 indicates that this treatment had been questioned vigorously by the audit manager but had been agreed with the audit partner, James Cowell. James Cowell subsequently left the firm abruptly.

You have received a copy of the 20X8 draft accounts which show an interest cover of 2.02 for 20X7 and 2.01 for 20X8. You have also been told that a similar review of subscription income has been made for 20X8, with 40% being reclassified as consultancy work as in the previous year.

Requirement

What are the issues that you as auditor would need to consider in this situation?

See **Answer** at the end of this chapter.

6 Money laundering regulations

Section overview

- Here, we consider an overview of the money laundering regulations in Bangladesh, and how they affect the work of accountants in practice.
- Reporting Entity and the role of accountants as reporting entity

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6.1 Money laundering regulations in Bangladesh

In Bangladesh, money laundering is governed by the Money Laundering Prevention Act, 2012 (amended in 2015) (the "Act"). The Act outlines several provisions to combat and prevent money laundering activities in the country.

The Bangladesh Financial Intelligence Unit (BFIU) is the central agency in Bangladesh responsible for combating money laundering and terrorist financing. It operates under the jurisdiction of the Central Bank of Bangladesh (i.e., Bangladesh Bank). Financial Intelligent Unit (FIU) of Bangladesh was established in June 2002. However, it was transformed into BFIU in 25 January 2012.

Here are some key provisions from the Act:

- Definition of Money Laundering: The Act defines money laundering as knowingly moving, converting, or transferring proceeds of crime or property involved in an offense for the purpose of concealing or disguising its illicit origin.

- Offenses and Penalties: Engaging in money laundering activities is a criminal offense. The penalties for money laundering can include imprisonment and fines. The severity of the penalty depends on the extent of the offense.
- Reporting Obligations: Financial institutions and non-financial businesses are required to report suspicious transactions to the Bangladesh Financial Intelligence Unit (BFIU). These reports help in identifying and investigating potential money laundering activities.
- Customer Due Diligence (CDD): Financial institutions must conduct customer due diligence to verify the identity of their clients and assess the risk of money laundering. This includes obtaining information on the beneficial ownership of accounts.
- Record Keeping: Financial institutions are required to maintain records of transactions and customer information for a specified period. This helps in tracking and investigating suspicious activities.
- Freezing and Seizure of Assets: The Act provides for the freezing and seizure of assets suspected to be involved in money laundering. This is to prevent the dissipation of assets before they can be confiscated.
- International Cooperation: The Act emphasizes cooperation with foreign jurisdictions in the investigation and prosecution of money laundering offenses. Bangladesh can share information and assist in cross-border investigations.
- Regulatory Authorities: The Bangladesh Financial Intelligence Unit (BFIU) is the primary regulatory body responsible for overseeing compliance with money laundering laws. It also has the authority to investigate and take action against violators.
- Protection for Whistleblowers: The Act includes provisions to protect individuals who report suspicious activities or cooperate with investigations into money laundering.

Here are some key provisions from BFIU:

- Establishment and Function: The BFIU is tasked with receiving, analyzing, and disseminating information related to suspicious financial transactions. It acts as the national center for receiving reports on suspicious activities and transactions.
- Regulatory Oversight: The BFIU supervises and monitors financial institutions and other reporting entities to ensure compliance with anti-money laundering (AML) and combating the financing of terrorism (CFT) regulations. It issues guidelines and directives to enhance the effectiveness of the AML/CFT regime in Bangladesh.
- Suspicious Transaction Reports (STRs) and Cash Transaction Reports (CTRs): Financial institutions and other entities are required to submit STRs and CTRs to the BFIU. The unit analyzes these reports to detect patterns of money laundering and terrorist financing activities.
- International Cooperation: The BFIU collaborates with foreign financial intelligence units and international organizations to exchange information and participate in global efforts to combat money laundering and terrorist financing. Bangladesh is a member of the Egmont Group, an international network of financial intelligence units.
- Capacity Building and Training: The BFIU provides training and capacity-building programs for financial institutions, law enforcement agencies, and other stakeholders to enhance their understanding of AML/CFT measures and improve their ability to detect and prevent financial crimes.
- Public Awareness and Outreach: The BFIU conducts public awareness campaigns and outreach programs to educate the public and private sectors about the risks and consequences of money laundering and terrorist financing.

- Policy Formulation: The BFIU plays a crucial role in formulating policies and strategies to strengthen the AML/CFT framework in Bangladesh. It advises the government on necessary legislative and regulatory measures to address emerging threats.

6.2 Reporting Entity

- bank
- financial institution
- insurer
- money changer
- any company/institution remitting or transferring money or money value
- any other institution carrying out its business with the approval of Bangladesh Bank
- stock dealer and stockbroker, portfolio manager and merchant banker, securities custodian, asset manager
- non-profit organization
- non-government organization
- cooperative society
- Real estate developer
- dealer in precious metals or stones
- trust and company service provider
- lawyer, notary, other legal professional and accountant
- any other institution which Bangladesh Bank may, from time to time, notify with the approval of the Government

6.3 Role of accountants as reporting entity

Chartered Accountant involved in any of the following activities on behalf of the client shall submit suspicious transaction if relevant:

- Buying or selling of real estate
- Managing client money security and other assets
- Management of bank saving and securities account
- Organization of contribution for the creation, operation or management of companies
- Creating, operating or management of legal persons or arrangement and buying or selling of business entities
- Or engage in Trust and company service providers in the following activities:
  - Acting as a formation agent of a legal person
  - Acting as director or secretary of a company or partner of a partnership or similar position
  - Providing registered office, business address accommodation, correspondence address
  - Acting or arranging nominee shareholder for another person

Context example: Greensill, Gupta, the former PM and the auditors

At the time of writing, the FRC has launched investigations into the audits conducted by two UK firms with connections to the collapsed supply chain finance company Greensill Capital and global steel magnate Sanjeev Gupta. Greensill made headlines in 2021 when it emerged that former UK prime minister David Cameron had attempted to secure government loans for Greensill Capital, raising questions over the ethics of lobbying. The finance was expected to have been used to continue Greensill's operations – facilitating the payment of suppliers for companies with liquidity issues – but was declined. Greensill collapsed soon after, leaving questions for its external auditors to answer about the unexpected nature of its swift demise.

Greensill had provided funding for the many companies operating under Sanjeev Gupta's steel empire, including Liberty Steel in the UK, but the withdrawal of insurance cover is considered pivotal in its inability to continue to trade, leaving Mr Gupta's network of companies vulnerable. In May 2021, the UK's Serious Fraud Office launched an investigation into alleged money laundering and fraud relating to loans between Greensill and companies under Mr Gupta, regarding the circumstances surrounding emergency government funding that was approved in order to support companies affected by the global pandemic. In June 2021, the FRC launched an investigation of its own into the audit of Wyelands Bank, also part of Mr Gupta's empire, which is thought to be connected to Greensill and this funding.

These investigations are likely to take some time to complete and may end up being completed by the FRC's successor ARGA, but they highlight the strain being put on a regulatory regime still reeling from the impacts of Carillion.

Sources: BBC News (2021) *Greensill auditor under investigation by watchdog* [Online]. Available from: https://www.bbc.co.uk/news/business-57634849 [Accessed 27 May 2022];

Smith R., Pooler M. and Storbeck, O. (2021) *The unravelling of Lex Greensill: a mix of bravado and financial alchemy* [Online]. Available from: https://www.ft.com/content/7e79117f-cbf5-4765-82ca- 7e8f1fb5915b [Accessed 27 May 2022].

7 Ethical guidance in more detail

7.1 Integrity, objectivity and independence

7.1.1 Exam focus

You will have covered the ethical guidance on integrity, objectivity and independence in your earlier studies. At the Advanced Level, however, a greater emphasis will be placed on your ability to apply this knowledge. Ethical dilemmas which you may be required to deal with will be less clear-cut and the requirements of the question will not always specifically indicate that ethical issues need to be considered. Instead information will typically be embedded within the question and you will need to demonstrate your skill in identifying the ethical issue and its implications.

This section provides a summary of the key points. It has been structured around the ethical issues, as this is the way that it will be examined at the Advanced Level.

Definitions

Integrity: Being trustworthy, straightforward, honest, fair and candid; complying with the spirit as well as the letter of the applicable ethical principles, laws and regulations; behaving so as to maintain the public's trust in the auditing profession; and respecting confidentiality except where disclosure is in the public interest or is required to adhere to legal and professional responsibilities.

Objectivity: Acting and making decisions and judgments impartially, fairly and on merit (having regard to all considerations relevant to the task in hand but no other), without discrimination, bias, or compromise because of commercial or personal self-interest, conflicts of interest or the undue influence of others, and having given due consideration to the best available evidence.

Independence: Freedom from conditions and relationships which, in the context of an engagement, would compromise the integrity or objectivity of the firm or covered persons.

Reasonable and informed third party: Consideration of whether the ethical outcomes required by the overarching principles and supporting ethical provisions have been met should be evaluated by reference to the perspective of an objective, reasonable and informed third party (sometimes referred to as the 'Third Party Test').

Covered person: A person in a position to influence the conduct or outcome of the engagement.

Close family: A non-dependent parent, child or sibling.

Person closely associated: This is:

(a) a spouse, or partner considered to be equivalent to a spouse in accordance with national law;

(b) a dependent child;

(c) a relative who has lived in the same household as the person with whom they are associated for at least one year;

(d) a firm whose managerial responsibilities are discharged by, or which is directly or indirectly controlled by, the firm/person with whom they are associated, or by any person mentioned in (a), (b) or (c) or in which the firm or any such person has a beneficial or other substantially equivalent economic interest; or

(e) a trust whose managerial responsibilities are discharged by, or which is directly or indirectly controlled by, or which is set up for the benefit of, or whose economic interests are substantially equivalent to, the firm/person with whom they are associated or any person mentioned in (a), (b) or (c).

7.1.2 Self-interest threat

Financial interests	The parties listed below are **not allowed** to own a direct financial interest or an indirect material financial interest in an audited entity:
	• The audit firm • Any partner in the audit firm • Any person in a position to influence the conduct and outcome of the engagement ie, a covered person (eg, a member of the engagement team) • Any person closely associated with any such partner or covered person The following **safeguards** will therefore be relevant: • Disposing of the interest • Removing the individual from the team if required • Keeping the audited entity's audit committee informed of the situation • Using an independent partner to review work carried out if necessary

Business relationships (eg, operating a joint venture between the firm and the client)	Firms, covered persons and persons closely associated with them must not enter into business relationships with any entity relevant to the engagement, or its management or its affiliates except where those relationships involve the purchase of goods on normal commercial terms and which are not material to either party or would be inconsequential in the view of an objective, reasonable and informed third party. Where a business relationship exists that is not permitted and has been entered into by the following parties: (a) The firm: either the relationship is terminated or the firm does not accept/withdraws from the engagement (b) A covered person: either the relationship is terminated or that person is excluded from any role in which they would be a covered person (c) A person closely associated with a covered person: either the relationship is terminated or the covered person is excluded from any role in which they would be a covered person.
Employment with assurance client	When a **partner** leaves the firm they may not be appointed as a director or to a key management position/ member of the audit committee with an audited entity, having acted as statutory auditor or key audit partner in relation to that audit before the end of: (a) in the case of a public interest entity, two years; and (b) in any other case, one year. Where a partner approved as statutory auditor is appointed as a director, a member of the audit committee or to a key management position having previously been a covered person: (a) in the case of a partner, at any time during the two years before the appointment; or (b) in the case of another person, at any time during the year before the appointment the firm must resign from the engagement where possible under applicable law or regulation. The firm cannot accept another engagement for the entity until: (a) in the case of a partner, a two-year period; or (b) in the case of another person, a one year period.
Governance role	The audit firm, a partner or employee of an audit firm shall not perform a role as an officer or member of the board of an entity relevant to the engagement.
Family and personal relationships	Where a covered person or any partner in the firm becomes aware that a person closely associated with them is employed by an entity and that person is in a position to exercise influence on the accounting records and financial statements relevant to the engagement they should be excluded from any role in which they would be a covered person eg, they should be removed from the audit team. Where a covered person or any partner in the firm becomes aware that a close family member who is not a person closely associated with them is employed by an entity and that person is in a position to exercise influence

	on the accounting records and financial statements relevant to the engagement they should report the matter to the engagement partner to take appropriate action. If it is a close family member of the engagement partner, the matter should be resolved in consultation with the Ethics Partner/Function.
Gifts and hospitality	Gifts, favours or hospitality should not be accepted unless an objective, reasonable and informed third party would consider the value to be trivial and inconsequential.
Loans and guarantees	Firms, covered persons and persons closely associated with them **must not enter into any loan or guarantee arrangement** with an audited entity that is not a bank or similar institution, and the transaction is made in the ordinary course of business on normal business terms and is not material to the entity.
Overdue fees	Firms should guard against fees building up, as the audit firm runs the risk of effectively making a loan. Where the amount cannot be regarded as trivial the engagement partner and ethics partner must consider whether it is necessary to resign. Generally, the payment of **overdue fees** should be required before the assurance report for the following year can be issued.
Percentage or contingent fees	Fees for the provision of engagements, non-audit and audit-related services to an entity relevant to an engagement, its parent undertaking and any worldwide controlled undertaking **shall not be contingent fees**. The firm and any of its network firms shall not provide any non-audit /additional services, to or in respect of an entity relevant to an engagement, wholly or partly on a contingent fee basis
High percentage of fees	The Ethical Standard includes a 70% cap in respect of non-audit services provided to an audit client as follows: (a) Total fees for non-audit services provided to a public interest entity audit client must be limited to no more than 70% of the average fees paid in the last three consecutive financial years for the audit. (b) Total fees for such services provided by the audit firm must be limited to no more than 70% of the average of the fees paid to the audit firm in the last three consecutive financial years for the audits of the entity. Where total fees (audit and non-audit services) from an audited entity are expected to regularly exceed 15% of the annual fee income of the audit firm (10% in the case of a public interest entity or other listed entity), the firm should resign or not stand for reappointment. Where total fees from an audited entity are expected to regularly exceed 10% of the annual fee income, but will not regularly exceed 15% (5% and 10% in the case of a public interest entity or other listed entity) the audit engagement partner should disclose that fact to the ethics partner and those charged with governance of the audited entity and consider whether appropriate safeguards should be applied to reduce the threat to independence. Non-public-interest entities will also require an external independent quality control review to be undertaken if the 10-15% category applies.
Lowballing	Where the fee quoted is significantly lower than would have been charged by the predecessor firm, the engagement partner must be satisfied that: • the **appropriate staff** are used **and time** is spent on the engagement; and • all applicable **assurance standards, guidelines** and **quality control procedures** have been complied with.

	The engagement partner must be able to demonstrate that the engagement has assigned to it sufficient partners and staff with appropriate time and skills, irrespective of the fee charged. Fees must not be influenced or determined by the provision of non-audit/additional services to an entity.

7.1.3 Self-review threat

Service with an assurance client	Individuals who have been a director or officer of the client, or an employee in a position to exert direct and significant influence over the financial statements on which the firm will express an opinion should not be assigned to the audit team. The Ethical Standard states that in this situation the individual should be excluded from any role in which they would be a covered person for a period of two years following the date of leaving the entity.
Preparing accounting records and financial statements	The Ethical Standard prohibits the provision of accounting services where: (a) the entity is a listed entity; or (b) for any other entity if those accounting services would involve the firm undertaking the role of management or the services are anything other than routine and mechanical, requiring little or no professional judgement. Where accounting services are provided, **safeguards** include: • using staff members other than engagement team members to carry out work; • a review of the accounting services provided by a partner or other senior staff member with relevant expertise who is not a member of the engagement team; and • a review of the engagement by a partner or other senior staff member with relevant expertise who is not a member of the engagement team. BSEC CG Guideline states that firms should not prepare accounts for financial statements for listed audited entities.
Provision of other services	BSEC CG Guideline states that firms should not provide other non audit services for listed audited entities These include: • Valuation services • Taxation services • Internal audit services • Corporate finance services • Information technology services • Litigation support services While in principle the provision of other services is allowed to non- listed clients, the threat of self-review must be considered particularly where the matter in question will be material to the financial statements. Safeguards may mitigate the threats in some circumstances. In particular, the service should not be provided where the audit firm would undertake part of the role of management.

7.1.4 Advocacy threat

Arises where the assurance firm is in a position of taking the client's part in a dispute or somehow acting as their advocate. Examples: If the firm carried out corporate finance work for the client; eg, if the audit firm were involved in advice on debt restructuring and negotiated with the bank on the client's behalf. • If the firm offered legal services to a client and, say, defended them in a legal case.	The Ethical Standard prohibits the provision of **legal services** for public interest entities with respect to: • the provision of legal counsel; • negotiating on behalf of the audit client; and • acting in an advocacy role in the resolution of litigation. For other entities legal services should not be provided where it would involve acting as the solicitor formally nominated to represent the client in resolution of a dispute or litigation which is material to the financial statements.

7.1.5 Familiarity threat

Long association	The Ethical Standard also requires all firms to monitor the relationship between staff and established clients. As per the IESBA Code, for audits of Public Interest Entities, an individual cannot serve as the engagement partner, the person responsible for the engagement quality control review, or any other key audit partner role (or a combination of these roles) for more than seven cumulative years. This duration is referred to as the "time-on period." After this period, the individual must observe a cooling-off period as specified in paragraphs R540.11 to R540.19. The cooling-off periods are as follows for individuals who have held these roles for seven cumulative years: • Engagement partner: five consecutive years • Individual responsible for the engagement quality control review: three consecutive years • Individual who has acted in any other key audit partner role: two consecutive years Under the jurisdictional provision, where a legislative or regulatory body (or organization authorized or recognized by such legislative or regulatory body) has established a cooling-off period for an engagement partner of less than five consecutive years, that shorter cooling-off period may be applied, subject to a floor of three years, provided that the applicable time-on period does not exceed seven years. In Bangladesh, the mandatory rotation of auditors for banks, finance companies, and listed companies is governed by regulations set by the Bangladesh Bank and the Bangladesh Securities and Exchange Commission (BSEC). According to the guidelines issued by the Bangladesh Bank, banks and NBFIs must rotate their external auditors every three years. An audit firm can be reappointed after a break of one year following the completion of its three-year term. In some cases, banks and finance companies may be

	required to appoint joint auditors. This means that two separate audit firms are engaged simultaneously to conduct the audit, enhancing audit quality and oversight. The Bangladesh Securities and Exchange Commission (BSEC) mandates that listed companies must rotate their auditors every three years. An audit firm can be reappointed after a break of one year. This means that even if the firm remains the same, the lead audit partner must be changed after a specified period, typically five years.
Recruitment and remuneration services	The firm **shall not provide recruitment services** to an entity relevant to an engagement, that would involve the firm taking responsibility for, or advising on the appointment of any director or employee of the entity, or a significant affiliate of such an entity, where the firm is undertaking an engagement. (Ethical Standard s.5.85) The firm **shall not provide advice on the remuneration package or the measurement criteria** on which the remuneration is calculated, for any director or employee of the entity, or a significant affiliate of an entity relevant to an engagement. (Ethical Standard s.5.86)

7.1.6 Intimidation threat

Litigation	Generally, where litigation threatens integrity, objectivity and independence, the normal course of action would be for the firm to resign. However, the firm is not required to resign immediately in circumstances where a reasonable and informed third party would not regard it in the interests of the shareholders for it to do so. This might be the case where: • the litigation was started as the engagement was about to be completed and shareholders would be adversely affected by the delay; or • on legal advice, the firm deems that the litigation is designed solely to bring pressure to bear on the auditor's opinion.

7.1.7 Management threat

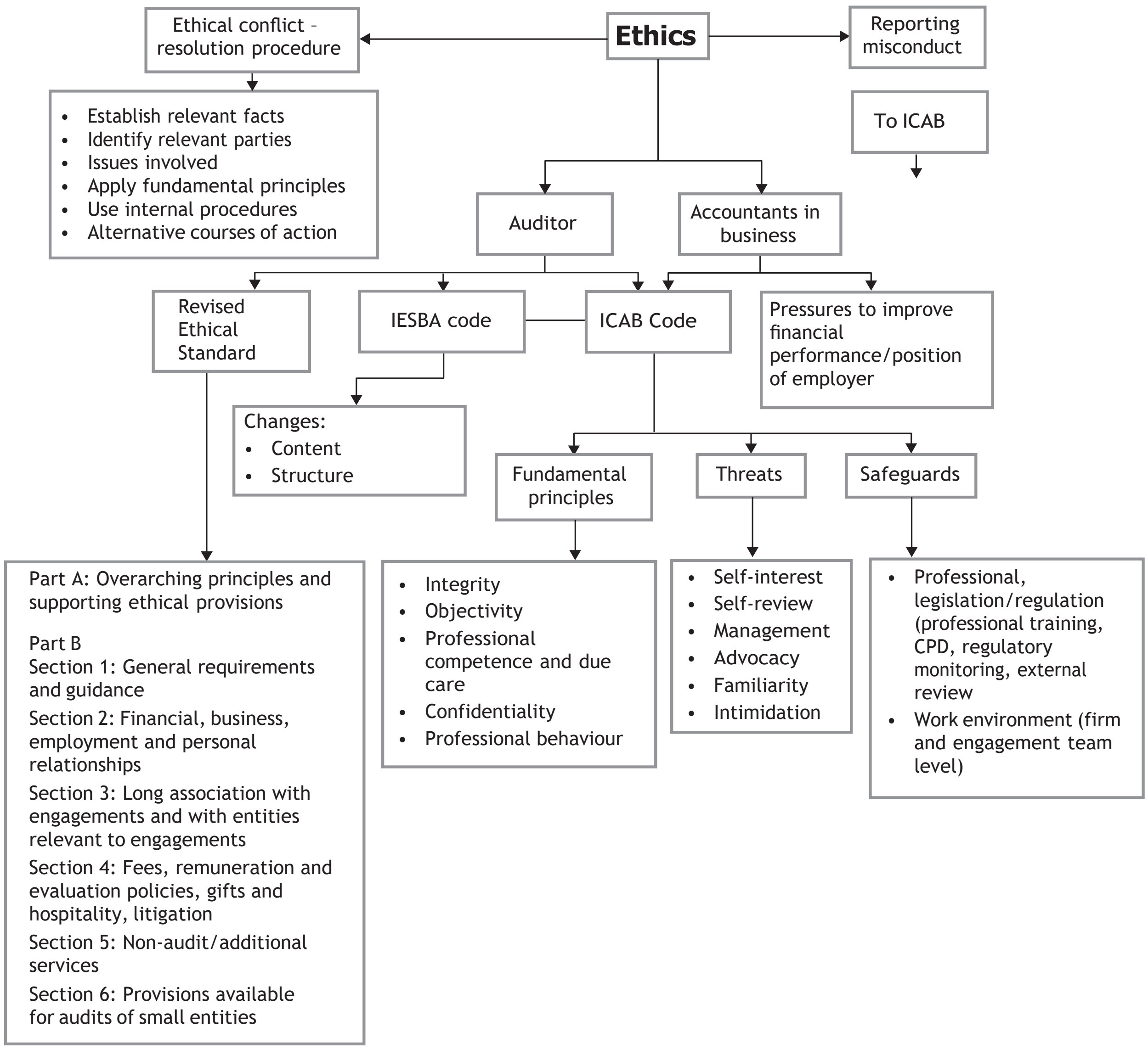
Arises when the firm undertakes non-audit services for audit clients which involves making judgements and taking decisions that are the responsibility of management (and due to the alignment of such responsibilities could diminish the firm's professional scepticism)	• If there is **informed management** (ie, management capable of making independent judgements and decisions on the basis of the information provided) safeguards may be able to mitigate the threat • If there is no informed management, it is unlikely that the threat can be avoided if the work is undertaken.

Note: A given situation may give rise to more than one threat.

Professional skills focus: Concluding, recommending and communicating

Questions are unlikely to simply ask you what the problem is - they will also expect some form of recommended action for the firm or accountant to take. Each part of the various Codes and Standards is designed to suggest responses but it is up to you to explain what you believe to be the right one and why.

Summary


Ethics
Ethical conflict - resolution procedure
Reporting misconduct
To ICAB
• Establish relevant facts
• Identify relevant parties
• Issues involved
• Apply fundamental principles
• Use internal procedures
• Alternative courses of action
Auditor
Accountants in business
Revised Ethical Standard
IESBA code
ICAB Code
Pressures to improve financial performance/position of employer
Changes:
• Content
• Structure
Fundamental principles
Threats
Safeguards
Part A: Overarching principles and supporting ethical provisions
Part B
Section 1: General requirements and guidance
Section 2: Financial, business, employment and personal relationships
Section 3: Long association with engagements and with entities relevant to engagements
Section 4: Fees, remuneration and evaluation policies, gifts and hospitality, litigation
Section 5: Non-audit/additional services
Section 6: Provisions available for audits of small entities
• Integrity
• Objectivity
• Professional competence and due care
• Confidentiality
• Professional behaviour
• Self-interest
• Self-review
• Management
• Advocacy
• Familiarity
• Intimidation
• Professional, legislation/regulation (professional training, CPD, regulatory monitoring, external review
• Work environment (firm and engagement team level)

Further question

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Can you identify behaviour in a given scenario that may be considered unethical?
2.	Do you know the various ethical codes and standards that you are expected to use and can you find them in your open book permitted text?
3.	Can you differentiate between the ethical issues faced by accountants in business and by auditors working in practice?
4.	Can you identify the various threats raised by certain situations and explain the most suitable response?
5.	Are you aware of current developments in response to money laundering?

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Easter	Use this as good practice of how to interrogate the open book permitted text for responses to a series of discrete ethical scenarios.
Marden plc	Having looked at some individual issues, now attempt something more exam-standard where you have to unpick the ethical issues from a larger and more complex scenario.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios that will help you improve your knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Poe, Whitman and Co	Here, you have been asked about practical and ethical issues related to your late appointment as group auditor. This requires a more methodical approach to consider the issues when reading the whole scenario.
UHN	This is a self-contained requirement to consider a one-off assignment but in the field of cyber-security – this presents a number of threats so your answer should adopt as broad a scope as possible.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving on to the next chapter.

CHAPTER 3

Technical reference

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Self-test questions

Answer the following questions

1 Easter

You are a partner in a firm of chartered accountants. The following issues have emerged in relation to three of your clients:

(1) Easter is a major client. It is listed on a major exchange. The audit team consists of eight members, of whom Paul is the most junior. Paul has just invested in a personal pension plan that invests in all the listed companies on the exchange.

(2) While listed, Easter has subsidiaries in five different European countries. Tax regimes in those countries vary on the absolute rate of tax charged as well as expenses allowable against taxable income. The Finance Director of Easter has indicated that the Easter group will be applying management charges between different subsidiaries to take advantage of favourable tax regimes with the five countries. The FD reminds you that another firm offering assurances services, Bunny & Co, has already approved the management charges as part of a special review carried out on the group and the FD therefore considers the charges to be legal and appropriate to Easter.

(3) You are at the head of a team carrying out due diligence work at Electra, a limited company which your client, Powerful, is considering taking over. Your second in command on the team, Peter, who is a manager, has confided in you that in the course of his work he has met the daughter of the Managing Director of Electra, and he is keen to invite her on a date.

(4) Your longest standing audit client is Teddies, which you have been involved in for 10 years, with four years as engagement partner. You recently went on an extended cruise with the Managing Director on his yacht. The company is not a public interest entity or listed entity.

(5) You are also aware that the executive directors of Teddies were recently voted a significant increase in bonus by their audit committee. The financial statements of Teddies do show a small improvement in net profit, but this does not appear to justify the extent of bonus paid. You are also aware that the Finance Director of Teddies is a non-executive director of Grisly, while the Senior Independent Director of Teddies is the Finance Director of Grisly.

Requirement

Comment on the ethical and other professional issues raised by the above matters.

Note: Your answer should outline the threat arising, the significance of the threat, any factors you have taken into account and, if relevant, any safeguards you could apply to eliminate or mitigate against the threat.

2 Saunders plc

Bourne & Berkeley is an assurance firm with a diverse range of audit clients. One client, Saunders plc, is listed on the stock exchange. You are the engagement partner on the audit; you have been engagement partner for four years and have an experienced team of eight staff to carry out the audit. The audit is made slightly more complicated because Bourne & Berkeley rent office space from Saunders plc. The total rental cost of that space is about 10% of the total income from Saunders plc. Office space is made available to other companies, including Walker Ltd, another of your audit clients. You are aware from the audit of Walker Ltd that the company is close to receivership and that the rent arrears is unlikely to be paid by Walker to Saunders.

In an interesting development at the client, the Finance Director resigned just before the audit commencing and the board asked Bourne & Berkeley for assistance in preparing the financial statements. Draft accounts were available, although the final statutory accounts had not been produced.

As part of your review of the draft accounts you notice that the revenue recognition policy includes an estimate of future revenues from the sale of deferred assets. One of the activities of Saunders plc is the purchase of oil on the futures market for delivery and resale between 6 and 12 months into the future. As the price of oil rises, the increase has been taken to the statement of profit or loss and other comprehensive income. When queried, the directors of Saunders state that while the accounting policy is new for the company, it is comparable with other firms in the industry and they are adamant that no amendment will be necessary to the financial statements. They are certain that other assurance firms will accept the policy if asked.

Requirement

Discuss the ethical and professional issues involved with the planning of the audit of Saunders plc.

3 Marden plc

At 6pm on Sunday evening a text message arrives for you from your audit manager, John Hanks, stating:

"Please check your email urgently"

On checking your email, you find the following message.

"I hope you had a good weekend. Instead of coming into the office tomorrow morning I would like you to go to a client called Marden plc. I know you have not worked on this client before so I am emailing you some background information (**Exhibit 1**). One of our audit juniors, Henry Ying, was at Marden's head office last week working on the interim audit and he has come up with a schedule of issues that are worrying me (**Exhibit 2**). Henry does not have the experience to deal with these, so I would like you, as a senior, to go out there and prepare a memorandum for me which sets out the financial reporting implications of each of these issues. I would also like you to explain in the memorandum the ethical issues that arise from these issues and the audit procedures required for each of the matters on Henry's schedule. I will visit Marden on Tuesday to speak to the directors.

John"

Requirement

Prepare the memorandum requested by your audit manager.

Exhibit 1: Background information

Marden plc operates a fleet of 10 executive jets available for private hire. The jets are based in Europe, the US and the Far East, but they operate throughout the world. The company is resident in the UK.

The jets can be hired for specific flights, for short periods or for longer periods. For insurance purposes, all planes must use a pilot employed by Marden. All the jets are owned by Marden.

Marden has an Alternative Investment Market listing. Ordinary share capital consists of five million £1 shares. The ownership of share capital at 1 January 20X6 was:

Directors	25%
Financial institutions	66%
Jack Airlines plc	9%

The company uses an interest rate of 10% to discount the cash flows of all projects. The accounting year end is 31 December.

Exhibit 2: Interim audit issues Prepared by Audit Junior: Henry Ying

In respect of the interim audit of the financial statements for the year to 31 December 20X6 the following issues have arisen.

(1) Marden appears to have inadvertently filed an incorrect tax return for last year showing a material understatement of its corporation tax liability for that year and has therefore paid significantly less corporation tax than it should have. Our firm is not engaged as tax advisers. The directors are now refusing to inform HM Revenue & Customs of the underpayment, as they say that 'it is in the past now'. I am not sure of our firm's obligations in this matter.

(2) One of the directors, Dick Tracey, owns a separate travel consultancy business. He buys unused flying time from Marden to sell to his own clients. In the year to 31 December 20X6 to date he has paid Marden £30,000 for 100 hours of flying time made available.

(3) On 16 September 20X6 a major customer, Stateside Leisure Inc, gave notification to Marden that the service it had been receiving was poor and it was therefore considering terminating its long- term contract with the company. The contract amounted to 15% of Marden's revenue and 25% of its profit in 20X5. The directors did not make an immediate announcement of this and so the share price did not initially change. Four directors sold a total of 200,000 shares in Marden plc on 2 October 20X6. Stateside Leisure Inc terminated the contract on 1 November 20X6 and the directors disclosed this to the London Stock Exchange the same day. The price per share then fell immediately from £7.50 to £6.

(4) Our audit fee for the year to 31 December 20X5 is still outstanding and is now overdue by five months.

(5) I have selected a sample jet to be physically inspected. I selected this jet because it does not appear to have flown since December 20X5. The jet in question cost £6 million on 1 January 20W8 and has a useful life of 10 years with a residual value of £1 million. Each jet is expected to generate £2 million income per year net of expenses.

    The directors say that this jet is located in the US, but they have offered to fly a member of our audit team out there in one of their executive jets. They insist that a jet needs to go there anyway so there would be no cost to Marden by making transport available to us.

(6) On 28 August 20X6 Jack Airlines plc – a large, listed company which operates a discount airline – acquired 1 million shares in Marden from financial institutions. On 20 October 20X6 Jack Airlines plc announced to the London Stock Exchange that it intends to make a bid for the entire share capital of Marden and at the same time requested that our firm, as Marden's auditors, should carry out the due diligence work in respect of the bid.

    Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

1.1 Factors

The request was made by her superiors.

- Financially she may have felt pressure to keep her job.
- Potential prospect of being rewarded through promotion and pay rises.
- Inability to decide how to deal with the situation.

1.2 Other courses of action

She could have:

- refused to make the adjustments;
- brought the matter to the attention of other senior members of staff eg, internal audit;
- resigned;
- sought advice from her relevant professional body;
- sought legal advice; or
- reported the matter to the relevant authorities eg, SEC at an earlier stage.

Answer to Interactive question 2

Potential ethical risk areas

Personal interests	Review of your own work	Disputes	Intimidation
Undue dependence on an audit client due to fee levels	Auditor prepares the accounts	Actual litigation with a client	Any threat of litigation by the client
Overdue fees becoming similar to a loan	Auditor participates in management decisions	Threatened litigation with a client	Personal relationships with the client
An actual loan being made to a client	Provision of any other services to the client	Client refuses to pay fees and they become long overdue	Threat of any services being put out to tender
Contingency fees being offered			
Accepting commissions from clients			
Provision of lucrative other services to clients			
Relationships with persons in associated practices			
Relationships with the client			

Personal interests	Review of your own work	Disputes	Intimidation
Long association with clients			
Beneficial interest in shares or other investments			
Hospitality			

Answer to Interactive question 3

3.1 Issues

(1) Teresa is at present a member of the engagement team and a member of her immediate family now owns a direct financial interest in the audit client. This is unacceptable.

If someone closely associated with a covered person holds a financial interest in the audit client, Stewart Brice needs to apply the following safeguards:

- Ensure that this person disposes of the shares immediately
- Remove Teresa from the engagement team (FRC Ethical Standard, para 2.9)

The financial interest has arisen from an inheritance by Teresa's husband, who has indicated that he would like to keep hold of the investment. The FRC ES paras. 2.11-12 requires that these shares should be disposed of as soon as possible and while this is being arranged, Teresa should be removed from the engagement team.

The firm should appraise the audit committee of Recreate of what has happened and the actions it has taken. The partners should consider whether it is necessary to bring in an independent partner to review audit work. However, given that Teresa's involvement is subject to the review of the existing engagement partner and she was not connected with the shares while she was carrying out the work, a second partner review is likely to be unnecessary in this case.

(2) The audit firm has an indirect financial interest in the parent company of a company it has been invited to tender for by virtue of its pension scheme having invested in Tadpole Group. The FRC ES would classify this indirect financial interest as a diversified collective investment scheme.

This is no barrier to the audit firm tendering for the audit of Kermit Co.

Should the audit firm win the tender and become the auditors of Kermit Co it should consider whether it is necessary to apply safeguards to mitigate against the risk to independence on the audit as a result of the indirect financial interest.

The factors that the partners will need to consider are the materiality of the interest to either party and the degree of control that the firm actually has over the financial interest. (FRC Ethical Standard, para. 2.13, 2.19)

In this case, the audit firm has no control over the financial interest. An independent pension scheme administrator is in control of the financial interest. In addition, the interest is unlikely to be substantial and is therefore immaterial to both parties. It is likely that this risk is already sufficiently minimal as to not require safeguards. However, if the audit firm felt that it was necessary to apply safeguards, it could consider the following:

- Notifying the audit committee of the interest
- Requiring Friends Benevolent to dispose of the shares in Tadpole Group

3.2 In this case, Stewart Brice has a direct financial interest in the audit client, which is technically prohibited by ethical guidance. However, it is a requirement of any firm auditing the company that the share be owned by the auditors.

The interest is not material. The audit firm should safeguard against the risk by not voting on its own re-election as auditor. The firm should also strongly recommend to the company that it removes this requirement from its constitution, as it is at odds with ethical requirements for auditors.

Answer to Interactive question 4

The issues to consider would include the following:

- Whether the management have made the decision to make the change in accounting treatment of a proportion of the subscription income on a valid and ethical basis.
- Management are under pressure not to breach the loan covenants. With the change in timing of the recognition the interest cover is only just achieved in both 20X7 and 20X8. This suggests that without this change the covenant would be breached indicating that profit levels are sensitive.
- The auditor's responsibility to all stakeholders, including shareholders.
- In this case the auditor would have a legal and moral responsibility to the venture capitalists who have invested in Bellevue Ltd, to ensure that profits are fairly stated.
- The implications of the disagreement with the treatment by the audit manager in 20X7 which was overruled by the partner. This is now of particular concern, as the audit partner has left the firm abruptly. This potentially raises questions about the integrity of the partner.
- Whether there is sufficient evidence to support the conclusion that some of the subscription fees are consultancy in nature and should therefore be recognised as the work is completed ie, when the performance obligation is satisfied (IFRS 15) rather than being recognised over the duration of the contract.
- Whether fees treated as subscription fees in previous years should have been recognised as consultancy fees resulting in the need for a prior-period adjustment.
- The basis on which the figure of 40% was established and whether there is evidence to support this estimation, particularly as this is exactly the same percentage as applied in 20X7.
- The overall increase in audit risk due to the need to comply with the loan agreement.

Answers to Self-test questions

1 Easter

Issues

(1) In relation to Easter, there is a threat of self-interest arising, as a member of the audit team has an indirect financial interest in the client.

The relevant factors are as follows:

- The interest is unlikely to be material to the client or Paul, as the investment is recent and Paul's interest is in a pool of general investments made in the exchange on his behalf.
- Paul is the audit junior and does not have a significant role on the audit in terms of drawing audit conclusions or audit risk areas.

The risk that arises to the independence of the audit here is therefore not significant. It would be inappropriate to require Paul to divest his interest in the audit client. If I wanted to eliminate all elements of risk in this situation, I could simply change the junior assigned to my team, but such a step is not vital in this situation.

(2) Regarding the management charges, there is a threat that the management charges are accepted as correct, simply because another assurance firm has recommended those charges to Easter.

To query the charges could imply a lack of trust in Bunny, with the possible effect of bringing the profession into disrepute. There is a risk that you as the assurance professional may not have the necessary knowledge to determine whether or not Easter has been acting correctly. There is also an intimidation threat in that the client is implying the charges are valid as another assurance firm has recommended the changes.

The relevant factors to take into account include the following:

- The legality or otherwise of the transactions. Information concerning the management charges must be obtained and compared to the law, not only of the individual countries but also of the EU as a whole. It remains a possibility that Easter has acted in accordance with laws of individual jurisdictions, but not the EU overall.
- Your level of knowledge. Where necessary, specialist advice must be obtained from the taxation department to determine the legality or otherwise of the transactions.
- The materiality of the management charges involved and the reduction in the taxation expense. Given that Easter is attempting to minimise its taxation charge, then the amounts are likely to be material and therefore as the audit firm, the transactions will have to be audited.
- Your knowledge of Bunny & Co. The assurance firm may well be skilled in advising on this type of issue, in which case there is likely to be less of an issue with the legality of the charges. However, if the reputation of Bunny is suspect, then additional work on the management charges may be required.

The intimidation threat is significant; it is unlikely that Easter would expect your firm to query the charges as another professional firm has confirmed them. A discussion with the FD may be required to confirm the purposes of the audit and the extent of evidence required to reach an audit opinion. Material transactions affecting the financial statements and taxation charges must be subject to standard audit procedures.

Your potential lack of knowledge is relatively easy to overcome. Specialist advice can be obtained from the taxation department, with a tax manager/partner being present in any discussion with the client to determine legality of the management charges.

(3) In relation to Powerful, two issues arise.

The first is that the firm appears to be providing multiple services for Powerful, which could raise a self-interest threat. The second is that the manager assigned to the due diligence assignment wants to engage in a personal relationship with a person connected to the subject of the assignment, which could create a familiarity or intimidation threat.

With regard to the issue of multiple services, insufficient information is given to draw a conclusion as to the significance of the threat. Relevant factors would be such matters as the nature of the services, the fee income and the team members assigned to each. Safeguards could include using different staff for the two assignments and review by a partner not connected to the Powerful engagement.
The risk is likely to be significant only if one of the services provided is audit, which is not indicated in the question.

In relation to the second issue, the relevant factors are these:

- The assurance team member has a significant role on the team as second in command.
- The other party represents a close family member at the company being reviewed.
- Timing.

In this situation, the firm is carrying out a one-off review of the company, and timing is a key issue. Presently Peter does not have a personal relationship which would significantly threaten the independence of the assignment. In this situation, the safeguard is to request that Peter does not take any action in that direction until the assignment is completed. If he refuses, then I may have to consider rotating my staff on this assignment, and removing him from the team.

(4) In relation to Teddies, there is a risk that my long association and personal relationship with the client will result in a familiarity threat.

This is compounded by my acceptance of significant hospitality on a personal level. The

relevant factors are as follows:

- I have been involved with the client for 10 years and have a personal relationship with client staff.
- The company is not a listed or public interest company.
- It is an audit assignment.

The risk arising here is significant but, as the client is not listed, it is not insurmountable. However, it would be a good idea to implement some safeguards to mitigate against the risk. I could invite a second partner to provide a hot review of the audit of Teddies, or even consider requesting that I am rotated off the audit of Teddies for a period, so that the engagement partner is another partner in my firm. In addition, I must cease accepting hospitality from the directors of Teddies unless it is clearly trivial and inconsequential.

If the independence issue cannot be resolved then the audit firm may also consider resigning from the audit of Teddies.

(5) It appears that there are cross-directorships between Teddies and Grisly.

In other words, at least one executive in Teddies assists in setting the bonuses of directors in Grisly, and at least one executive in Grisly is involved in setting the bonuses of directors in Teddies. This issue provides an independence threat for those directors, especially so if the FDs are members of a professional body such as ICAB.

There is a further point, that you as engagement partner are aware of the issue, but your independence may be compromised by the cruise with the managing director. There is also the issue of the lack of clear reporting obligations in this situation. Most codes of corporate governance require the directors of the company to make statements of compliance with that code, and in many situations cross-directorships are not explicitly banned.

Factors to consider include:

- Whether the directors are members of a professional body. If so, the engagement partner could tactfully ask whether there are independence conflicts and how these will be resolved.
- The level of bonuses awarded in Grisly. If these appear to be nominal then the issue of lack of independence regarding the bonuses in Teddies is reduced.
- Whether Teddies has audit and remuneration committees and whether these are effective in determining director remuneration and communicating concerns of the auditor to the board. As auditor, you have access to the audit committee but not the remuneration committee, so there is no precise way of raising concerns with the remuneration committee.
- To a certain extent, the association threat of being linked to a client where the code of corporate governance may not be being followed.

As the engagement partner, it would be appropriate to mention the perceived lack of independence with the Finance Director. This may be directly rather than via the audit committee due to the lack of communication you have with the remuneration committee. The result of any communications must be documented in the audit file, even where communication is simply verbal.

The association risk is probably minimal, although will increase where your firm also provides assurance services to Grisly. Where there are significant and continued breaches of the code of governance, then your firm may consider not acting for Teddies in the future. Provision of additional disclosure is compromised by lack of reporting obligations and your independence issue with the managing director of Teddies.

2 Saunders plc

Issues

(1) The rental of the premises from an audit client represents a business relationship which poses a potential threat to objectivity.

- Bourne & Berkeley would be able to continue to act if the arrangement is:
  - in the ordinary course of business;
  - on an arm's length basis; and
  - not material to either party.
- In this case the rental income is likely to be material to the audit client, as it represents 10% of total income.
- The audit firm would need to take immediate steps to terminate either the client or the business relationship.

(2) The Ethical Standard prohibits accounts preparation work for listed company audit clients.

- In this case it is likely that the preparation of the financial information will involve the auditor in making subjective judgements, as the internal reporting format will need to be converted into the statutory format. Decisions will need to be made about, for example, the level and nature of disclosures. This would constitute an accountancy service and would not be allowed.

(3) There is a conflict of interest here.

While it may be in the interest of Saunders plc for the auditor to disclose the information regarding the recoverability of the debt, this information is confidential, as it was obtained in the course of audit work performed for Walker Ltd. Disclosure of this information to Saunders plc would breach the duty of confidentiality.

- The Code of Ethics requires that the auditor should disclose a conflict of interest to the parties involved. In this case, however, the situation is complicated by the fact that the conflict of interest has had a practical consequence rather than simply being a potential problem. In addition, it may be difficult to make the communication without revealing confidential information.
- The firm should consider whether there were sufficient procedures in place to prevent the conflict of interest occurring in the first place.
- The Code states that the auditor should take steps to identify circumstances that could pose a conflict of interest and to put in place any necessary safeguards eg, use of separate audit teams.
- If procedures were inadequate this may have implications for other clients.
- If the balance is not material further action is unlikely to be necessary. If the balance is material the situation will need to be addressed.
- Saunders plc may be aware of the potential irrecoverability of the debt and an allowance for an irrecoverable receivable may have been made in the financial statements.
- If an adjustment has been made and the auditor is in agreement with it no further action would be required.
- Independent evidence may be available which would indicate that the debt was irrecoverable. For example, there may have been correspondence between Saunders plc and Walker Ltd concerning the payment of the balance. There may also be evidence in the public domain, for example newspaper reports and the results of credit checks. However, the auditor would need to consider how this evidence was used, particularly if it was sought as a result of having the confidential information.
- The audit manager could consider requesting Walker Ltd to communicate with Saunders plc.
- This may not be acceptable to Walker Ltd, who may feel that any communication would not be in their interest. It may also make any future relationship between the auditor and Walker Ltd difficult.
- If the issue cannot be resolved and the balance is material the auditor will not be able to form an audit opinion. Bourne & Berkeley will need to consider resigning as the auditor of Saunders plc.

(4) Revenue recognition policy

It appears that Saunders plc is attempting to implement a change in accounting policy which increases revenue, while at the same time intimidating the auditors to accept this policy. There is an implied threat that Bourne & Berkeley will be removed from office if the accounting policy is not accepted.

Factors to consider include the following:

- The materiality of the amounts involved. Given that the accounting policy is an attempt to increase revenue, the amount is likely to be material – again it would be unlikely that the directors would want to spend the time and effort if this was not the case.

- The accounting policies adopted by similar firms in the industry. The directors of Saunders have noted that the income recognition policy is the same as other firms in the industry. Accounts of similar firms need to be obtained and the accounting policies checked. If the policies are the same as Saunders, and the technical department of Bourne & Berkeley confirm that the policy follows GAAP, then no modification of the auditor's report will be required, although audit evidence will be obtained to confirm the correct application of the policy. If the revenue recognition policy is inappropriate, then additional discussion will be required with the directors to determine whether they will continue with the policy, and risk a modified report, or amend the policy.
- Whether the directors would actually seek to remove Bourne & Berkeley if the revenue recognition policy does not follow GAAP and the auditor's report will be modified. The audit firm needs to document the situation and be prepared to provide a statement on why it is being removed in accordance with Companies Act requirements.

Bourne & Berkeley will find it difficult to remove the intimidation threat. Advice can be obtained from the ethics partner, although it is unlikely that the firm's position can be defended by agreeing to an accounting policy if this does not follow GAAP. Bourne & Berkeley will need to maintain its integrity by insisting that appropriate accounting policies are followed, even where this risks losing an audit client.

3 Marden plc

MEMO

To Audit manager From Audit senior Date XX-XX-XX

Re Accounting issues of Marden plc

(1) Understatement of tax liability Audit and ethics

The understatement of the tax liability is an illegal act by the client. Tuesday's meeting offers the opportunity to attempt to persuade the client even at this late stage.

Consider whether a partner needs to be at the meeting given the ethical importance of the issue. The key issue is the conflict between our duty to report and our duty of confidentiality.

According to ethical requirements in terms of reporting, this may be:

- where there is a duty to disclose
- where there is a right to disclose

Suggested actions if the client continues to refuse to disclose to HMRC:

- Our views should be put in writing to the client
- Report to the audit committee if there is one
- Refer the matter to senior personnel in our firm – eg, the ethics partner
- The firm must consider whether to cease to act for the client
- Consider whether this is a 'whistleblowing' incident in the public interest

Financial reporting

If there is a material unrecognised liability in the financial statements then we need to consider whether the financial statements give a true and fair view. Any material understatement of the tax provision would need to be reflected in the auditor's report. The level of detail as to the cause of the misstatement raises confidentiality considerations.

(2) Related party transaction Audit and ethics

The audit issue in this case is that there is a potential conflict of interest between a director and the body of shareholders.

Directors also have a fiduciary duty to act in the interests of all shareholders. Directors must not place themselves in a position where there is a conflict of interest between their personal interests and their duty to the company (Regal (Hastings) Ltd v Gulliver). In certain circumstances the company may void such contracts.

More specifically, the audit risk in this case is that the price of £30,000 for the use of the jet might not be an arm's length price in terms of an hourly rate for this type of hire. At £300 per hour including the pilot's time there is a risk that the director, Dick Tracey, may be exploiting his position.

The Companies Act imposes restrictions on the dealings of directors with companies in order to prevent directors taking advantage of their position. This applies even where the directors are shareholders, but particularly where the interests of non-controlling, or outside, shareholders may be damaged.

If there has not been knowledge and approval of the transactions by the other directors then there may be an issue of false accounting by Dick Tracey.

Audit procedures:

- Review provisions in Articles of Association regarding directors' contracts with the company
- Examine the terms of the contract(s) ascertaining the nature of the hire agreements
- Ascertain whether any similar arm's length hires took place and at what prices (see evidence of such agreements where appropriate)
- Ascertain whether the other directors were aware of the nature and extent of the hire contracts (eg, review correspondence)
- Review board minutes to see if the hire contracts have been considered and formally approved by the board

Financial reporting

Transactions involving directors are required to be disclosed in the financial statements by both the Companies Act 2006 and IAS 24, *Related Party Disclosures*.

A director is part of key management personnel and thus is a related party of the company. According to IAS 24 the transaction should be disclosed irrespective of its materiality. However, the name of the director need not be disclosed.

As a result, the hire fees are likely to be deemed to be a related party transaction and thus the following disclosures should be made:

- Amounts involved
- Amounts due to or from the related party
- Irrecoverable debt write-offs to or from the related party

(3) Directors' share trading Audit and ethics

There are two issues in this case:

- The failure to make a timely disclosure for personal gain by the directors
- The consequences of the underlying event of the loss of a major contract

The failure to announce the loss of the contract might leave the directors in breach of their fiduciary duty to shareholders, as they may have manipulated the market for their own gain.

Consider taking legal advice as to whether an illegal act has been committed, as the initial communication from Stateside in September was only about poor service. The formal notification of the contract being terminated by Stateside was immediately communicated to the London Stock Exchange by the directors. If this is considered illegal, it could represent money laundering under the Proceeds of Crime Act and as such, care must be taken to avoid tipping off.

Consider also taking advice as to whether stock market rules have been breached by the directors individually and by the company. This might affect quality of markets and may be contrary to insider trading laws.

Regarding the underlying event of the loss of a major customer, consideration needs to be given as to whether going concern is affected by the loss of such a large contract (eg, if the service is poor, will other major contracts be lost?).

Financial reporting

Consider whether any provision is necessary once advice is received on whether the company has committed an illegal act (as opposed to the directors themselves) or has been in breach of regulations. Provisions might include fines or other penalties imposed by the courts or regulators.

If there has been a significant decline in activity, then impairment needs to be considered on the jets if their value in use has decreased.

Consider recoverability of amounts outstanding from Stateside Leisure Inc.

(4) Audit fee outstanding Audit and ethics

It may be that the matter of the overdue fees can be resolved amicably at Tuesday's meeting.

If, however, the fee remains outstanding, it may be a threat to our independence. This may be because it biases our opinion against the client. Alternatively, it may be that we do not wish to put the client's going concern at risk, as this may reduce the likelihood of us receiving payment.

In effect, the overdue fee may be similar to a loan to the client which is not permitted. Actions may include the following:

- A review by an independent partner (perhaps the ethics partner) who is not involved in the audit to agree that the objectivity of the engagement staff is not affected. This should really have been completed before commencement of the audit so it is now a matter of urgency.
- If legal action is necessary to recover the fees it would not be possible for us to continue acting for the client, as the Revised Ethical Standard 2019 prohibits, in most circumstances, auditors acting for clients where there is actual or potential litigation between the two parties.

Financial reporting

A provision should be made for the audit fee outstanding.

(5) Physical inspection of jets Audit and ethics

There are two issues here.

- The fact that one jet appears not to have been used
- The offer of 'free' transport on an executive jet may be deemed as a gift

The fact that a jet has not been used for some time may have a number of possible causes.

- Technical problems – the jet may not be serviceable. We need to establish whether this is the case (eg, hire an independent local aircraft engineer) then consider impairment testing.
- Lack of markets – there may be insufficient demand to warrant using the plane. This seems less likely, as the plane has not been used at all. Examine usage of other Marden planes in the US.
- Unrecorded usage – the jet may be being used but the usage is unrecorded and income understated. Alternatively, it might mean that improper use is being made of the company's assets (eg, by management).

Regarding the 'free' flight, gifts beyond what is considered trivial and inconsequential are not permitted. However, if the flight were merely for the purpose of the audit check and there were no added benefits (additional destinations, trips etc) then it may be permissible if agreed by the ethics partner.

Alternatively, a local firm of auditors could be used. The check might not just be the physical verification of the asset but also usage records (eg, flying logs, pilots' time).

Financial reporting

The jet has not been used for some time and therefore impairment testing needs to be considered.

Technical problems – The jet may not be fully serviceable, in which case it needs to be reviewed for impairment according to IAS 36 as both fair value and value in use may be affected.

The carrying amount at 31 December 20X6 of the jet is £1.5 million (ie, £6m – [£5m × 9/10])

The value in use, if fully operational (assuming year-end operating cash flows and including the residual amount) is:

(£2m + £1m)/1.1 = £2.73m

Thus, there is no impairment if the plane is fully operational (the fair value less costs of disposal calculation is not necessary as the value in use exceeds the carrying amount).

However, if the plane is not operational then both next year's net operating inflow and the residual value are likely to be affected. In this case an impairment charge of £1.5 million (less the present value of any residual value obtainable for a non-operational jet) may be required.

Lack of markets – There may be insufficient demand to warrant using the plane. This will affect value in use but perhaps not the residual value. Again, impairment testing may be needed as according to IAS 36 value in use may be affected.

If the jet is not operational next year, but can be sold for a residual value of £1 million next year (although selling immediately would be a better option in this case) the impairment charge is:

£1.5m – £1m/1.1 = £0.59m

Unrecorded usage – This may mean that any depreciation based on the amount of flying time may be understated.

Any impairment on this aircraft might have further implications for impairment of other aircraft if the cause is market based rather than technically based.

(6) Due diligence assignment Audit and ethics

Acceptance of the due diligence assignment is not permitted, as there would be a conflict of interest between our role as auditor of Marden and a due diligence role for the bidder for Marden, Jack Airlines plc.

The acquisition of one million shares would take Jack Airlines to a 29% holding (Note: 30% is the maximum permitted by the stock exchange before an offer needs to be made to all shareholders). The offer is therefore for the remaining shares. This is a key audit risk, as directors still hold a significant amount of the shares and this may influence their financial reporting, as the share price will be affected by the bid.

It might be noted that the announcement was made during the period that the share price was artificially inflated due to the Stateside Leisure Inc announcement, and this may ultimately affect the bid.

Financial reporting

There is no direct effect on the financial statements; however, consider:

- if the bid process is going into next year and the bid is to be defended, then a provision may need to be made for defence costs; and
- if the bid process is going into next year, then disclosure of the bid as a non-adjusting event after the reporting date may be necessary.

Chapter 4

Corporate governance

Introduction

Learning outcomes

- Explain and appraise the nature and consequences of corporate governance and accountability mechanisms in controlling the operating and financial activities of entities of differing sizes, structures and industries
- Explain the rights and responsibilities of the board, board committees (eg, audit and risk committees), those charged with governance and individual executive and non-executive directors, with respect to the preparation and audit of financial statements
- Explain and appraise the rights and responsibilities of stakeholder groups (eg, executive management, bondholders, government, securities exchanges, employees, public interest groups, financial and other regulators, institutional and individual shareholders) with respect to the preparation and audit of financial statements
- Evaluate and appraise appropriate corporate governance mechanisms
- Explain and evaluate the nature and consequence of relevant corporate governance codes and set out the required compliance disclosures
- Explain the principles, practices and disclosures of corporate governance
- Explain the respective responsibilities of those charged with governance and auditors for corporate risk management and risk reporting
- Explain the respective responsibilities of those charged with governance and auditors in respect of internal control systems
- Explain and evaluate the role and requirement for effective two-way communication between those charged with governance and auditors
- Describe and explain the roles and purposes of meetings of boards and of shareholders

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	**Relevance of corporate governance** To recap the topic, we have a section designed to remind you of what corporate governance is and why it is necessary.	**Approach** Remind yourself of the various milestones in corporate governance history. **Stop and think** Can you think of any other examples of poor governance like we saw at VW?	Questions in the exam will require you to evaluate the governance arrangements in place in a given scenario.	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive questions
2	**Corporate governance concepts** Do you know the basic underpinning concepts of sound corporate governance?	**Approach** Make sure you can explain each of these terms. **Stop and think** Which of these concepts do you think is the most important?	Instead of focusing on processes, you may wish to explain poor governance in terms of the underlying concepts that are in place which may not be in the spirit of good governance.	N/A
3	**The BSEC Corporate Governance Code** You need to be able to discuss the various principles and provisions currently in use in the BSEC Code.	**Approach** Make sure you understand the BSEC Code. **Stop and think** If required, could you explain which parts of the Governance Code require formal disclosure by a company?	When questions are written for the exam, it is likely that they will use the BSEC Code as a starting point, so make sure you are familiar with the BSEC Code.	**IQ1: BSEC Corporate Governance Code** As well as knowing about the BSEC Code, you may also need to explain how it is used (and even how it could be used).
4	**Role of the board** Can you remember what board members are responsible for?	**Approach** Use this section to recap the various responsibilities of board members. **Stop and think** Can you discuss the benefits and drawbacks associated with non-executive directors?	You may need to advise a non-executive director so it is helpful to consider their role and background to make sure that your tone is appropriate.	N/A
5	**Associated guidance** Additional publications exist to support good governance in other areas.	**Approach** Read through each one to make sure you are familiar with the content. **Stop and think** Can you explain why each of these publications might be necessary?	Consider whether any of these could be helpful in responding to requests in exam questions where the BSEC Code does not apply.	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive questions
6	**Corporate governance: international impact** What does the rest of the world do when it comes to promoting sound corporate governance?	**Approach** Review the Sarbanes-Oxley and G20/OECD guidance. **Stop and think** Compare and contrast these approaches with the BSEC Code - why are there differences?	Be prepared for exam questions to feature governance outside the country.	N/A
7	**Corporate governance and internal control** One of the key elements of sound governance is the management of risk and the use of sound systems of internal control.	**Approach** Use the guidance to see how this can be applied in a practical context. **Stop and think** Can you differentiate between the approaches used by WH Smith and Coca Cola?	You will have studied risk management and internal control in previous subjects so remember that they can also be examined in governance context.	N/A
8	**Evaluation of corporate governance mechanisms** This is especially relevant to auditors as it includes the various governance disclosures that companies are required to make in their annual reports.	**Approach** Although you can see the BSEC Corporate Governance Guidelines and provisions, it is important that you can discuss them in the context of the audit. **Stop and think** Can you list the various disclosures that the auditor is required to review?	Going concern is an area that could easily be combined with a question on governance, so don't forget to consider this angle when attempting suitable questions.	N/A
9	**Communication between auditors and those charged with governance**	**Approach** Work through this section with the open book	Be prepared to explain how this form of communication	**IQ2: Reporting responsibilities** An efficient test of your understanding

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	This section deals with the internal communication between auditors and directors.	permitted text in front of you. **Stop and think** Can you map these points to where they are covered by ISAs 260 and 265?	operates if required in the exam.	of the various forms of communication that the auditor may need to make.

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

CHAPTER

4

1 Relevance of corporate governance

Section overview

- Concerns about the adequacy of financial reporting, a number of high profile corporate scandals in the 1990s and concerns about excessive directors' remuneration highlighted the need for effective corporate governance.
- Corporate governance can be defined as the system by which organisations are directed and controlled.
- The BSEC Corporate Governance Code was revised in October 2023.

1.1 Introduction

Corporate governance potentially covers a **wide range of issues** and disciplines from company secretarial and legal through business strategy, executive and non-executive management and investor relations to accounting and information systems.

Corporate governance issues came to prominence worldwide in the late 1980s. The main drivers associated with the increasing demand for developments in this area included the following:

(a) **Financial reporting**

Issues concerning **financial reporting** were raised by many investors and were the focus of much debate and litigation. Shareholder confidence in what was being reported in many instances was eroded. While corporate governance development is not just about better financial reporting requirements, the regulation of creative accounting practices, such as **off balance sheet financing**, has led to greater transparency and a reduction in risks faced by investors.

(b) **Corporate scandals**

The early 1990s saw an increasing number of high profile **corporate scandals** and collapses, including Polly Peck International, BCCI and Maxwell Communications Corporation. This prompted the development of governance codes in the early 1990s. However, the scandals since then, including Enron, have raised questions about further measures that may be necessary and the financial crisis in 2008–2009 triggered widespread reappraisal of governance systems.

(c) **Excessive directors' remuneration**

Directors being paid excessive salaries and bonuses has been seen as one of the major corporate issues for a number of years. While CEOs have argued that their packages reflect the global market, shareholders and employees are concerned that these are often out of step with the remuneration of other employees and do not reflect the performance of the company.

1.2 What is corporate governance?

There are a number of different definitions of corporate governance.

The following definition is taken from the Cadbury Report and is still relevant in the context of Corporate Governance Code.

Definition

Corporate governance: Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined... providing shareholders, board members and executives as well as financial intermediaries and service providers with the right incentives to perform their roles within a framework of checks and balances (OECD, 2015).

An alternative definition is: The set of processes, customs, policies, laws and institutions affecting the way in which an entity is directed, administered or controlled. Corporate governance serves the needs of shareholders, and other stakeholders, by directing and controlling management activities towards good business practices, objectivity and integrity in order to satisfy the objectives of the entity.

In essence, corporate governance:

- involves the management and reduction of risk;
- specifies the **distribution rights** and **responsibilities** among different participants in the corporation, such as the board, managers, shareholders and other stakeholders;
- spells out the **rules** and **procedures** for making decisions on corporate affairs;
- provides the **structure** through which objectives are set; and
- provides the **means of attaining the objectives** and **monitoring performance.**

It can be argued that good corporate governance:

- provides a **framework** for an organisation to pursue its strategy in an **ethical** and effective way and offers **safeguards** against the misuse of resources, human, financial, physical or intellectual;
- can attract **new investment** into companies, particularly in developing nations; and
- underpins **capital market confidence** in companies.

1.3 Features of poor corporate governance

The scandals over the last 30 years have highlighted the need for guidance to tackle the various risks and problems that can arise in organisations' systems of governance.

1.3.1 Domination by a single individual

A feature of many corporate governance scandals has been boards dominated by a single senior executive, with other board members merely acting as a rubber stamp. Sometimes the single individual may bypass the board to act in their own interests. Even if an organisation is not dominated by a single individual, there may be other weaknesses. The organisation may be run by a small group centred round the chief executive and chief financial officer, and appointments may be made by personal recommendation rather than a formal, objective process.

1.3.2 Lack of involvement of board

Boards that meet irregularly or fail to consider systematically the organisation's activities and risks are clearly weak. Sometimes the failure to carry out proper oversight is due to a **lack of information** being provided.

1.3.3 Lack of adequate control function

An obvious deficiency is a **lack of internal audit**.

Another important control deficiency is **lack of adequate technical knowledge** in key roles, for example in the audit committee or in senior compliance positions. A rapid turnover of staff involved in accounting or control may suggest inadequate resourcing, and will make control more difficult because of lack of continuity.

1.3.4 Lack of supervision

Employees who are not properly supervised can create large losses for the organisation through their own incompetence, negligence or fraudulent activity. The behaviour of Nick Leeson, the employee whose trading losses caused the collapse of Barings Bank was not challenged because he appeared to be successful. Leeson was able to run up losses because he was in charge of dealing and settlement, a systems deficiency or **lack of segregation of key roles** that has featured in other financial frauds.

1.3.5 Lack of independent scrutiny

External auditors may not carry out the necessary questioning of senior management because of fears of losing the audit, and **internal audit** do not ask awkward questions because the chief financial officer determines their employment prospects. Often corporate collapses are followed by criticisms of external auditors, such as the Barlow Clowes affair where poorly planned and focused audit work failed to identify illegal use of client monies.

1.3.6 Lack of contact with shareholders

Often board members may have grown up with the company but lose touch with the interests and views of shareholders. One possible symptom of this is the payment of remuneration packages that do not appear to be warranted by results.

1.3.7 Emphasis on short-term profitability

Emphasis on success or getting results can lead to the **concealment of problems or errors**, or **manipulation of accounts** to **achieve desired results**.

1.3.8 Misleading accounts and information

Often misleading figures are symptomatic of other problems (or are designed to conceal other problems) but clearly poor quality accounting information is a major problem if markets are trying to make a fair assessment of the company's value. Giving out misleading information was a major issue in the UK's Equitable Life scandal, where the company gave contradictory information to savers, independent advisers, media and regulators.

1.4 Risks of poor corporate governance

Clearly the ultimate risk is of the organisation **making such large losses** that **bankruptcy** becomes inevitable. The organisation may also be closed down as a result of **serious regulatory breaches,** for example misapplying investors' monies.

Context example: VW

During 2015, it became apparent that car manufacturer Volkswagen (VW) had created software in its vehicles that was deliberately intended to allow its diesel vehicles to incorrectly pass engine emission tests which are used throughout the motor industry. Many observers have pointed out that such a practice could not have occurred without senior management approval: if this was the case, it suggests serious ethical flaws in the company's governance; if not, it still points to a company that is not in control of its staff.

Professional skills focus: Assimilating and using information

Often you will know that there is a problem but you may not be able to explain exactly what the problem is. Keep in mind the basic idea that there is something not right and then use it as a way of combing all the relevant facts until you can explain what the problem really is.

2 Corporate governance concepts

Section overview

- Corporate governance concepts include the following:
  - Fairness
  - Openness/transparency
  - Independence
  - Probity/honesty
  - Responsibility
  - Accountability
  - Reputation
  - Judgement
  - Scepticism
  - Innovation

One view of governance is that it is based on a series of **underlying concepts**. These are important, as good corporate governance depends on a willingness to apply the **spirit of the guidance** as well as the letter of the law.

2.1 Fairness

The directors' deliberations and also the systems and values that underlie the company must be **balanced** by taking into account everyone who has a legitimate interest in the company, and respecting their rights and views. In many jurisdictions, corporate governance guidelines reinforce legal protection for certain groups, for example minority shareholders.

2.2 Openness/transparency

In the context of corporate governance, transparency means **corporate disclosure to stakeholders**. Disclosure in this context obviously includes information in the financial statements, not just the numbers and notes to the accounts but also narrative statements such as the directors' report and the operating and financial review. It also includes all **voluntary disclosure**; that is, disclosure above the minimum required by law or regulation. Voluntary corporate communications include the following:

- Management forecasts
- Analysts' presentations
- Press releases
- Information placed on websites
- Other reports such as standalone environmental or social reports

The main reason why transparency is so important relates to the agency problem; that is, the potential conflict between owners and managers. Without effective disclosure the position could be unfairly weighted towards managers, since they normally have far more knowledge of the company's activities and financial situation than owners/investors. Reducing this **information asymmetry** requires not only effective disclosure rules but also strong internal controls that ensure that the information disclosed is **reliable**.

2.3 Independence

Independence is an important concept in relation to directors (as well as auditors). Corporate governance reports have increasingly stressed the importance of **independent non-executive directors**; directors who are not primarily employed by the company and who have very strictly controlled other links with it. They should be free from conflicts of interest and in a better position to **promote the interests of shareholders and other stakeholders**. Freed from pressures that could influence their activities, independent non-executive directors should be able to carry out **effective monitoring** of the company in conjunction with independent external auditors on behalf of shareholders and other stakeholders.

2.4 Probity/honesty

Hopefully this should be the most self-evident of the principles, relating not only to telling the truth but also to not **misleading** shareholders and other stakeholders by presenting information in a biased way.

2.5 Responsibility

For management to be held properly responsible, there must be a system in place that allows for **corrective action** and **penalising mismanagement**. Responsible management should do, when necessary, whatever it takes to set the company on the right path.

The board of directors must act responsively to, and with responsibility towards, all stakeholders of the company. However, the responsibility of directors to other stakeholders, both in terms of to **whom** they are responsible and the **extent** of their responsibility, remains a key point of contention in corporate governance debates.

2.6 Accountability

Corporate **accountability** refers to whether an organisation (and its directors) are answerable in some way for the consequences of their actions.

The board of directors is accountable to shareholders. However, making the accountability work is the responsibility of **both** parties. Directors, as we have seen, do so through the quality of information that they provide, whereas shareholders do so through their willingness to **exercise their responsibility as owners**, which means using the available mechanisms to query and assess the actions of the board.

As with responsibility, one of the biggest debates in corporate governance is the extent of management's **accountability** towards **other stakeholders**, such as the community within which the organisation operates.

2.7 Reputation

In the same way, directors' concern for an organisation's reputation will be demonstrated by the extent to which they fulfil the other principles of corporate governance. There are purely **commercial reasons** for promoting the organisation's reputation, namely that the price of publicly traded shares is often dependent on reputation and hence reputation can be a very valuable asset of the organisation.

2.8 Judgement

Judgement means the board **making decisions that enhance the prosperity** of the organisation. This means that board members must acquire a broad enough knowledge of the **business and its environment** to be able to provide meaningful direction to it. This has implications not only for the attention directors have to give to the organisation's affairs but also for the way the directors are recruited and trained.

The complexities of senior management mean that the directors have to bring **multiple conceptual skills** to management that aim to maximise long-term returns. This means that corporate governance can involve balancing many competing people and resource claims against each other.

2.9 Integrity

Integrity is straightforward dealing and completeness. What is required of financial reporting is that it should be honest and that it should present a balanced picture of the state of the company's affairs. The integrity of reports depends on the integrity of those who prepare and present them. It can be taken as meaning someone of **high moral character**, who sticks to principles no matter the pressure to do otherwise. In working life, this means adhering to principles of professionalism and probity.

Straightforward dealing in relationships with the different people and constituencies whom you meet is particularly important; trust is vital in relationships and belief in the integrity of those with whom you are dealing underpins this.

This definition highlights the need for **personal honesty and integrity** of preparers of accounts. This implies qualities beyond a mechanical adherence to accounting or ethical regulations or guidelines. At times accountants will have to use judgement or face financial situations which aren't covered by regulations or guidance, and on these occasions integrity is particularly important.

Integrity is an essential principle of the **corporate governance relationship**, particularly in relation to representing shareholder interests and exercising agency. As with financial reporting guidance, ethical codes don't cover all situations and therefore depend for their effectiveness on the qualities of the accountant. In addition, we have seen that a key aim of corporate governance is to inspire confidence in participants in the market and this significantly depends on a **public perception** of **competence and integrity**.

2.10 Scepticism

You should be familiar with the concept of '**professional scepticism**' from your earlier auditing studies: sound governance practices should also consider the importance of being sceptical about all parts of the business, regardless of whether they have displayed any evidence of dysfunctional behaviour. **For example**, if performance continues to exceed industry averages, even in periods of economic downturn, it could be symptomatic of fraudulent financial reporting.

2.11 Innovation

Change happens; factors such as technological advances, social behaviour, market expectations and even freak weather conditions can all have significant impacts on organisations and their stakeholders, which means that governance structures need to be **agile** and **responsive** in order to stay relevant.

3 The BSEC Corporate Governance Code

Section overview

- The Bangladesh Securities and Exchange Commission issued Corporate Governance Code in order to enhance corporate governance in the interest of investors and the capital market which was last revised in October 2023.
- The Code applies to all publicly listed companies in Bangladesh.
- The Code includes a number of requirements to ensure good governance in structure and practice including several disclosure requirements as well.
- Refer to the workbook of Corporate Laws and Practices at Professional Levels for details of the codes.

Similar Context example: British Airways

UK airline British Airways (BA) is a well-known company that is often used as the benchmark in its industry, yet in 2019 the roles of chair and chief executive were filled by the same individual. How was this allowed? BA is actually owned by the International Airlines Group (IAG) which at the time had a more robust governance structure of chair, 10 non-executive directors and two executive directors (finance director and chief executive). It is therefore important to understand the ownership structure of an entity when appraising how it is directed and controlled.

Professional skills focus: Structuring problems and solutions

Use the various principles and provisions of the Corporate Governance Code to help you structure an answer when presented with a series of governance issues.

Interactive question 1: Corporate Governance Code

Compliance with the Corporate Governance Code is a requirement of Bangladesh Securities and Exchange Commission for all publicly listed companies. Some argue that the Code should be mandatory for all companies.

Requirements

1.1 Discuss the benefits of the BSEC Corporate Governance Code to shareholders and other interested users of financial statements.

1.2 Discuss the merits and drawbacks of having a provision in the form of a voluntary application. See **Answer** at the end of this chapter.

4 Role of the board

Section overview

- The board of directors should be responsible for taking major **policy** and **strategic** decisions and use the best information available to it, reporting how they have fulfilled their duties.
- Directors should have a **mix of skills** and their **performance** should be assessed regularly.
- **Independent non-executive directors** have a key role in governance. Their number and status should mean that their views carry significant weight.

4.1 Scope of role

If the board is to act effectively, its role must be defined carefully. The Code suggests that the board should have a **formal schedule of matters** specifically reserved to it for decision. Some would be such decisions as **mergers and takeovers** that are **fundamental** to the business and therefore should not be taken just by executive managers. Other decisions would include **acquisitions and disposals of assets of the company** or its subsidiaries that are material to the company and **investments, capital projects, bank borrowing** facilities, **loans** and their repayment, and foreign currency transactions, all above a certain size (to be determined by the board).

Other tasks the board should perform include:

- monitoring the chief executive officer;
- overseeing strategy;
- monitoring risks and control systems;
- monitoring the human capital aspects of the company in regard to succession, morale, training, remuneration etc; and
- ensuring that there is effective communication of its strategic plans, both internally and externally.

Similar Context example: Role of the board

For the voluntary sector, the UK's *Good Governance, A Code for the Voluntary and Community Sector* stresses the board of trustees' role in ensuring compliance with the objects, purposes and values of the organisation and with its governing document. The Code stresses that the board must ensure that the organisation's vision, mission, values and activities remain true to its objects.

The Code also lays more stress than the governance codes targeted at listed companies on trustees focusing on the strategic direction of their organisation and not becoming involved in day to day activities. The chief executive officer should provide the link between the board and the staff team, and the means by which board members hold staff to account. Where in smaller organisations trustees need to become involved in operational matters, they should separate their strategic and operational roles.

4.2 Attributes of directors

In order to carry out effective scrutiny, directors need to have **relevant expertise** in industry, company, functional area and governance. The board as a whole needs to contain a **mix of**

expertise and show a **balance** between **executive management** and **independent non-executive directors**.

New and existing directors should also have **appropriate training** to develop the knowledge and skills required.

4.3 Possession of necessary information

As we have seen above, in many corporate scandals, the board was not given full information. The Code states that the chair is responsible for ensuring that the directors receive **accurate, timely and clear information**. Directors should seek clarification where necessary.

4.4 Performance of board

Appraisal of the board's performance is an important control over it. The **performance of the board** should be **assessed** once a year (for FTSE 350 companies this should be externally facilitated every three years).

4.5 Board membership and division of responsibilities

All reports acknowledge the importance of having a division of responsibilities at the head of an organisation. The simplest way to do this is to require the roles of **chair** and **chief executive** to be held by two different people.

Context example: Director Influence

Another area of concern is whether individual directors are exercising disproportionate influence on the company. For example, Boots prohibited the chair of the remuneration committee from serving on the audit committee and vice versa.

4.6 Non-executive directors

Non-executive directors have no executive (managerial) responsibilities.

Non-executive directors should provide a **balancing influence,** and play a key role in **reducing conflicts of interest** between management (including executive directors) and shareholders. They should provide reassurance to shareholders, particularly institutional shareholders, that management is acting in the interests of the organisation.

Context example: Sources of non-executive directors

Non-executive directors may come from a number of sources:

- Companies operating in international markets could benefit from having at least one non-executive director with international experience.
- Lawyers, accountants and consultants can bring skills that are useful to the board.
- Listed companies should consider appointing directors of private companies as non-executive directors.
- Including individuals with charitable or public sector experience but strong commercial awareness can increase the breadth of diversity and experience on the board.

4.7.1 Role of non-executive directors

The role of non-executive directors can be summarised as follows:

- **Strategy**: Non-executive directors should contribute to, and challenge the direction of, strategy.

- **Performance**: Non-executive directors should scrutinise the performance of management in meeting goals and objectives, and monitor the reporting of performance.
- **Risk**: Non-executive directors should satisfy themselves that financial information is accurate and that financial controls and systems of risk management are robust.
- **Directors and managers**: Non-executive directors are responsible for determining appropriate levels of remuneration for executives, and are key figures in the appointment and removal of senior managers and in succession planning.

4.7.2 Advantages of non-executive directors

Non-executive directors can bring a number of advantages to a board of directors.

- They may have **external experience and knowledge which executive directors do not possess**. The experience they bring can be in many different fields. They may be executive directors of other companies, and thus have experience of different ways of approaching corporate governance, internal controls or performance assessment. They can also bring knowledge of markets within which the company operates.
- Non-executive directors can provide a **wider perspective** than executive directors, who may be more involved in detailed operations.
- Good non-executive directors are often a **comfort factor** for third parties, such as investors and creditors.
- It has been suggested that there are **certain roles** non-executive directors are well suited to play. These include 'father-confessor' (being a confidante for the chair and other directors),'oil-can' (intervening to make the board run more effectively) and acting as 'high sheriff' (if necessary taking steps to remove the chair or chief executive).
- The most important advantage perhaps lies in the dual nature of the non-executive director's role. Non-executive directors are **full board members** who are expected to have the level of knowledge that full board membership implies. At the same time, they are meant to provide the so-called **strong, independent element** on the board. This should imply that they have the knowledge and detachment to be able to assess fairly the remuneration of executive directors when serving on the remuneration committee, and to be able to discuss knowledgeably with auditors the affairs of the company on the audit committee.

4.7.3 Problems with non-executive directors

Nevertheless, there are a number of difficulties connected with the role of non-executive director.

- In many organisations, non-executive directors may **lack independence**. There are in practice a number of ways in which non-executive directors can be linked to a company, as suppliers or customers for example. Even if there is no direct connection, potential non-executive directors are more likely to agree to serve if they admire the company's chair or its way of operating.
- There may be a **prejudice in certain companies** against widening the recruitment of non- executive directors to include people proposed other than by the board or to include stakeholder representatives.
- High-calibre non-executive directors may gravitate towards the **best-run companies**, rather than companies which are more in need of input from good non-executives.

- Non-executive directors may have **difficulty imposing** their views on the board. It may be easy to dismiss the views of non-executive directors as irrelevant to the company's needs. This may imply that non-executive directors need good persuasive skills to influence other directors. Moreover, if executive directors are determined to push through a controversial policy, it may prove difficult for the more disparate group of non-executive directors to oppose them effectively.
- It has been suggested that not enough emphasis is given to the role of non-executive directors in **preventing trouble**, in warning early on of potential problems. When trouble does arise, non- executive directors may be expected to play a major role in rescuing the situation, which they may not be able to do.
- Perhaps the biggest problem which non-executive directors face is the **limited time** they can devote to the role. If they are to contribute valuably, they are likely to have time-consuming other commitments. In the time they have available to act as non-executive directors, they must contribute as knowledgeable members of the full board and fulfil their legal responsibilities as directors. They must also serve on board committees. Their responsibilities mean that their time must be managed effectively, and they must be able to focus on areas where the value they add is greatest.

4.7.4 Independence of non-executive directors

Various safeguards can be put in place to ensure that non-executive directors remain independent. A number of factors will be considered, including if the director:

- has been an employee of the company within the last five years;
- has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
- receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
- has close family ties with any of the company's advisers, directors or senior employees;
- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- represents a significant shareholder; or
- has served on the board for more than nine years from the date of their first election.

Whenever a question scenario features non-executive directors, watch out for threats to, or questions over, their independence.

5 Corporate governance: international impact

Section overview

- Corporate governance models differ around the world, but the following principles and legislation are widely recognised:
  - The G20/OECD Principles of Corporate Governance (G20/OECD Principles)

- The Sarbanes–Oxley Act in the US (SOX)
- The BSEC Corporate Governance Code (covered in earlier sections)

- The G20/OECD Principles resulted from market pressure for standardisation of governance guidelines.
- The G20/OECD Principles are non-binding but are intended to assist governments, stock exchanges, investors and companies. They cover the following six areas:
  - Ensuring the basis for an effective corporate governance framework
  - The rights of shareholders
  - The equitable treatment of shareholders
  - The role of stakeholders
  - Disclosure and transparency
  - The responsibilities of the board
- The introduction of SOX in the US resulted from the Enron scandal.
- SOX is a 'rules-based' rather than 'principles-based' approach to improving corporate governance.
- The Act applies to all companies that are required to file accounts with the Securities and Exchange Commission. This includes non-US companies who list their shares in the US and therefore affects companies worldwide.
- SOX has resulted in increased compliance costs for companies.

5.1 G20/OECD Principles of Corporate Governance

5.1.1 Convergence of international guidance

Because of increasing international trade and cross-border links, there is significant pressure for the development of internationally comparable practices and standards. Accounting and financial reporting is one area in which this has occurred. Increasing international investment and integration of international capital markets has also led to pressure for standardisation of governance guidelines, as international investors seek **reassurance about the way their investments are being managed** and the **risks** involved.

5.1.2 OECD guidance

The Organisation for Economic Co-operation and Development (OECD) has carried out an extensive consultation with member countries, and developed a **set of principles of corporate governance** that countries and companies should work towards achieving. The OECD has stated that its interest in corporate governance arises from its concern for **global investment**. Corporate governance arrangements should be credible and understood across national borders. Having a common set of accepted principles is a step towards achieving this aim.

The OECD developed its Principles of Corporate Governance in 1998 and issued a revised version endorsed by the G20 in November 2015. They are **non-binding principles**, intended to assist governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries.

They are also intended to provide guidance to stock exchanges, investors and companies. The focus is on stock exchange listed companies, but many of the principles can also apply to private companies and state-owned organisations.

The G20/OECD Principles deal mainly with governance problems that result from the **separation of ownership and management** of a company. Issues of ethical concern and environmental issues are also relevant, although not central to the problems of governance.

Between February 2009 and February 2010 the OECD issued a number of documents regarding the corporate governance lessons which can be learnt from the recent financial crisis.

5.1.3 G20/OECD Principles

The G20/OECD Principles are grouped into six broad areas:

5.1.3.1 Ensuring the basis for an effective corporate governance framework

The corporate governance framework should promote **transparent and fair** markets, and the efficient allocation of resources. It should be consistent with the rule of law and support effective supervision and enforcement.

5.1.3.2 The rights and equitable treatment of shareholders and key ownership functions

Shareholders should have the right to **participate and vote in general meetings** of the company, **elect** and **remove members of the board** and **obtain relevant and material information** on a timely basis. All shareholders of the same class of shares should be treated equally, including **minority shareholders** and **overseas shareholders**. **Impediments** to **cross-border shareholdings** should be **eliminated**.

Capital markets for corporate control should function in an **efficient and timely manner**.

5.1.3.3 Institutional investors, stock markets and other intermediaries

Institutional investors acting in a fiduciary capacity should **disclose** their corporate governance and voting policies with respect to their investments and should disclose how they **manage material conflicts of interest**. Parties providing advice to investors should disclose and **minimise conflicts of interest**. Votes should be cast in line with the directions of the owners of the shares.

5.1.3.4 The role of stakeholders

Rights of stakeholders should be **protected**. All stakeholders should have **access to relevant information** on a regular and timely basis. **Mechanisms** for employee participation should be **permitted to develop**. Stakeholders, including employees, should be able to **freely communicate their concerns** about illegal or unethical relationships to the board and public authorities.

5.1.3.5 Disclosure and transparency

Timely and accurate disclosure must be made of all material matters regarding the company, including the financial situation, company objectives and non-financial information, major share ownership, including beneficial owners and voting rights, remuneration of members of the board and key executives, information about the board (including their qualifications), related party transactions, foreseeable risk factors, issues regarding employees and other stakeholders and governance structures and policies. Information should be prepared and disclosed in accordance with **standards of accounting and financial and non-financial reporting**. An **annual audit** should be conducted by an independent, competent and qualified auditor following relevant auditing standards. The auditor must exercise **due professional care** in the conduct of the audit. Information must be disseminated through proper channels.

5.1.3.6 The responsibilities of the board

The board is responsible for the **strategic guidance** of the company and for the **effective monitoring** of management. Board members should act on a fully informed basis, in good faith, with due diligence and care and in the **best interests of the company and its shareholders**. They should treat **all shareholders fairly**. The board should be able to exercise **independent judgement**; this includes assigning independent non-executive directors to appropriate tasks.

5.2 Sarbanes–Oxley and governance in the US

5.2.2 The Enron scandal

The most significant scandal in the US in recent years has been the Enron scandal, when one of the country's biggest companies filed for bankruptcy. The scandal also resulted in the disappearance of Arthur Andersen, one of the Big Five accountancy firms who had audited Enron's accounts. The main reasons why Enron collapsed were overexpansion in energy markets, too much reliance on derivatives trading which eventually went wrong, breaches of federal law, and misleading and dishonest behaviour. However, inquiries into the scandal exposed a number of weaknesses in the company's governance.

5.2.2.1 A lack of transparency in the accounts

This particularly related to certain investment vehicles that were not recognised in the statement of financial position. Various other methods of inflating revenues, offloading debt, massaging quarterly figures and avoiding taxes were employed.

5.2.2.2 Ineffective corporate governance arrangements

The company's management team was criticised for being arrogant and overambitious and there were potential conflicts of interest.

5.2.2.3 Inadequate scrutiny by the external auditors

Arthur Andersen failed to spot or question dubious accounting treatments. Since Andersen's consultancy arm did a lot of work for Enron, there were allegations of conflicts of interest.

5.2.2.4 Information asymmetry

That is, the agency problem of the directors/managers knowing more than the investors. The investors included Enron's employees. Many had their personal wealth tied up in Enron shares, which ended up being worthless. They were actively discouraged from selling them. Many of Enron's directors, however, sold the shares when they began to fall, potentially profiting from them.

5.2.2.5 Executive compensation methods

These were meant to align the interests of shareholders and directors, but seemed to encourage the overstatement of short-term profits. Particularly in the US, where the tenure of chief executive officers is fairly short, the temptation is strong to inflate profits in the hope that share options will have been cashed in by the time the problems are discovered.

5.2.3 The Sarbanes–Oxley Act 2002

In the US the response to the breakdown of stock market trust caused by perceived inadequacies in corporate government arrangements and the Enron scandal was the **Sarbanes–Oxley Act 2002.** The Act applies to all companies that are required to file periodic reports with the Securities and Exchange Commission (SEC). The Act was the most far-reaching US legislation dealing with securities in many years and has major implications for public companies. Rule-making authority was delegated to the SEC on many provisions.

Sarbanes–Oxley shifts responsibility for financial probity and accuracy to the board's **audit committee**, which typically comprises three independent directors, one of whom has to meet certain financial literacy requirements (equivalent to non-executive directors in other jurisdictions).

Along with rules from the SEC, the Sarbanes–Oxley Act (SOX) requires companies to increase their financial statement **disclosures**, to have an internal **code of ethics** and to impose **restrictions on share trading** by, and **loans to**, corporate officers.

Effectively the SOX legislates that companies and their boards must comply with provisions derived from principles similar to the OECD Principles and those contained in the UK Corporate Governance Code. However, this rules based approach has drawn criticism for its 'one size fits all' approach and there have been concerns that it unnecessarily burdens smaller entities.

Unlike the UK Corporate Governance Code, which adopts a 'comply or explain' approach, the SOX is strictly rules-based, with penalties imposed for non-compliance. There is a continuing debate around which approach is the more effective. It is argued that the UK's more flexible model:

- provides best practice guidance that can be applied to the varying circumstances of different companies;
- prevents the development of a mechanistic, 'box-ticking' approach to decision-making and the use of legalistic loopholes to avoid compliance with guidance; and
- focuses on the spirit of the guidance and encourages responsibility and the exercise of professional judgement.

On the other hand, supporters of a rules-based approach argue that compliance with such guidance is easier since the requirements are prescriptive and leave little room for misunderstanding.
Furthermore, rules-based approaches are easier to enforce.

5.2.4 Detailed provisions of the Sarbanes-Oxley Act

Note: This legislation was issued prior to the adoption of the quality management standards in 2021 when the term quality control was still in use however, in this instance you can assume that the law is referring to what you understand to be quality management.

These are as follows:

Public Oversight Board

The Act set up a new regulator, the **Public Company Accounting Oversight Board**, to oversee the audit of public companies that are subject to the securities laws.

The Board has powers to set **auditing, quality control, independence and ethical standards** for registered public accounting firms to use in the preparation and issue of audit reports on the financial statements of listed companies. In particular, the Board is required to set standards for registered public accounting firms' reports on listed company statements on their internal control over financial reporting. The Board also has **inspection and disciplinary powers** over firms.

Auditing standards

Audit firms should **retain working papers** for at least seven years and have **quality control standards** in place, such as second partner review. As part of the audit they should review internal control systems to ensure that they **reflect the transactions** of the client and provide **reasonable assurance** that the transactions are recorded in a manner that will **permit preparation** of the **financial statements** in accordance with **generally accepted accounting principles**. They should also review records to check whether **receipts** and **payments** are being made **only in accordance with management's authorisation**.

Non-audit services

Auditors are expressly prohibited from carrying out a number of services, including internal audit, bookkeeping, systems design and implementation, appraisal or valuation services, actuarial services, management functions and human resources, investment management, and legal and expert services. **Provision of other non-audit services** is only allowed with the **prior approval** of the **audit committee**.

Quality control procedures

There should be **rotation** of lead or reviewing audit partners every five years and other procedures such as independence requirements, consultation, supervision, professional development, internal quality review and engagement acceptance and continuation.

Auditors and audit committee

Auditors should discuss **critical accounting policies**, **possible alternative treatments**, the management letter and unadjusted differences with the audit committee.

Audit committee

Audit committees should be established by all listed companies.

All members of audit committees should be **independent** and should therefore not accept any **consulting** or **advisory fee** from the company or be affiliated to it. At least one member should be a financial expert. Audit committees should be responsible for the **appointment, compensation** and **oversight** of auditors. Audit committees should establish mechanisms for dealing with complaints about accounting, internal controls and audit.

Corporate responsibility

The chief executive officer and chief financial officer should certify the appropriateness of the financial statements and that those financial statements fairly present the operations and financial condition of the issuer. If the company has to prepare a restatement of accounts due to material non-compliance with standards, the chief financial officer and chief executive officer should forfeit their bonuses.

Off balance sheet transactions

There should be **appropriate disclosure** of **material off balance sheet transactions** and other relationships (transactions that are not included in the accounts but that impact on financial conditions, results, liquidity or capital resources).

Internal control reporting

Annual reports should contain **internal control reports**. We look at this aspect in more detail in section 7 when we consider internal control.

Whistleblowing provisions

Employees of **listed companies** and **auditors** will be granted whistleblower protection against their employers if they **disclose private employer information** to parties involved in a fraud claim.

5.2.5 Impact of Sarbanes–Oxley in the US

The biggest expense involving compliance that companies are incurring is fulfilling the requirement to ensure their **internal controls** are properly documented and tested. US companies had to have efficient controls in the past, but they are now having to document them more comprehensively than before, and then have the external auditors report on what they have done.

The Act also formally stripped accountancy firms of almost all non-audit revenue streams that they used to derive from their audit clients, for fear of conflicts of interest.

For lawyers, the Act strengthens requirements on them to whistleblow internally on any wrongdoing they uncover at client companies, right up to board level.

5.2.6 International impact of Sarbanes–Oxley

The Act also has a significant **international dimension**. About 1,500 non-US companies, including many of the world's largest, list their shares in the US and are covered by Sarbanes–Oxley. There were complaints that the new legislation conflicted with local corporate governance customs and, following an intense round of lobbying from outside the US, changes to the rules were secured. For example, German employee representatives, who are non-management, can sit on audit committees, and audit committees do not have to have board directors if the local law says otherwise, as it does in Japan and Italy.

Also, as the US is such a significant influence worldwide, arguably Sarbanes–Oxley may influence certain jurisdictions to adopt a more rules-based approach.

5.2.7 Criticisms of Sarbanes–Oxley

Sarbanes–Oxley has been criticised in some quarters for **not being strong enough** on certain issues, for example the selection of external auditors by the audit committee, and at the same time being over-rigid on others. Directors may be less likely to consult lawyers in the first place if they believe that legislation could override lawyer-client privilege.

In addition, it has been alleged that a Sarbanes–Oxley compliance industry has sprung up focusing companies' attention on complying with all aspects of the legislation, significant or much less important. This has distracted companies from **improving information flows** to the market and then allowing the market to make well-informed decisions. The Act has also done little to address the temptation provided by generous stock options to inflate profits, other than requiring possible forfeiture if accounts are subsequently restated.

Most significantly, perhaps, there is recent evidence of companies turning away from the US stock markets and towards other markets such as London. Many observers have suggested that this was partly due to companies tiring of the **increased compliance costs** associated with Sarbanes–Oxley implementation. In addition, the nature of the **regulatory regime** may be an increasingly significant factor in listing decisions.

While it is unlikely that you will be expected to consider the regulatory aspects of an

Professional skills focus: Assimilating and using information

organisation from the US in great detail, basic knowledge of Sarbanes-Oxley will help you with the headline issues.

5.3 International focus for internal control

As we discussed earlier, large international companies may be listed in the US and are required to comply with the US Sarbanes–Oxley Act 2002 (SOX).

The key difference between SOX and the UK approach to corporate governance is that while the UK Corporate Governance Code is principles-based, SOX is rules-based. By contrast to the UK's 'comply or explain' approach, most of the SOX regulations are enshrined in legislation, with penalties for non- compliance.

One area of this Act that has sparked widespread debate has been section 404 relating to the assessment of internal control. Under SOX, management and the auditors must report on the adequacy of the company's internal control over financial reporting. Working to implement, document and test controls to the degree required to make an assertion that the controls are adequate can be a costly and time-consuming process.

Annual reports for companies affected by SOX should contain **internal control reports** that state the responsibility of management for establishing and maintaining an **adequate internal control structure** and **procedures for financial reporting**. Annual reports should also contain an **assessment** of the **effectiveness** of the **internal control structure** and **procedures** for **financial reporting**. Auditors should report on this assessment.

Companies should also report whether they have adopted a **code of conduct** for senior financial officers and the content of that code.

5.3.1 Example of internal control report under SOX

The following extract has been taken from the annual report for 31 December 2017 of Coca-Cola Enterprises, Inc.

Management's report on internal control over financial reporting

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting as such term is defined in Rule 13a-15(f) under the Securities Exchange Act of 1934 ("Exchange Act"). Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2017. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (2013 Framework) ("COSO") in Internal Control–Integrated Framework. Management has excluded from the scope of its assessment of internal control over financial reporting the operations and related assets of Coca-Cola Beverages Africa Proprietary Limited ("CCBA"), which the Company began consolidating in October 2017. The operations and related assets of CCBA were included in the consolidated financial statements of The Coca-Cola Company and subsidiaries and constituted 8 percent of total assets and 8 percent of consolidated net income as of and for the year ended December 31, 2017. Based on this assessment, management believes that the Company maintained effective internal control over financial reporting as of December 31, 2017.

The Company's independent auditors, Ernst & Young LLP, a registered public accounting firm, are appointed by the Audit Committee of the Company's Board of Directors, subject to ratification by our Company's shareowners. Ernst & Young LLP has audited and reported on the consolidated financial statements of The Coca-Cola Company and subsidiaries and the

Company's internal control over financial reporting. The reports of the independent auditors are contained in this annual report.

Source: The Coca Cola Company (2018). ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (Online). Available at: https://investors.coca- colacompany.com/filings-reports/all-sec-filings/content/0000021344-18-000008/0000021344-18- 000008.pdf [Accessed 27 May 2022].

6 Communication between auditors and those charged with governance

Section overview

- Auditors have to communicate various audit-related matters to those charged with governance.
- This section summarises and builds on the important points covered by the Audit and Assurance paper at Professional Level.

6.1 Communication during the audit

Two standards are relevant here:

- ISA 260 (Revised), *Communication with Those Charged with Governance*
- ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*

The revisions to ISA 260 include the need to consider the implications of ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report* and enhanced auditor reporting for all public interest entities (PIEs) and listed companies.

Definition

Governance: The term used to describe the role of persons with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. Those charged with governance may include management only when it performs such functions.

6.1.1 Objectives

ISA 260 (Revised) states that the objectives of the auditor are to:

(a) communicate clearly with those charged with governance the **responsibilities of the auditor** in relation to the financial statement audit and an overview of the planned scope and timing of the audit;

(b) obtain from those charged with governance **information relevant to the audit**;

(c) provide those charged with governance with **timely observations** arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process; and

(d) promote effective **two-way communication** between the auditor and those charged with governance.

The auditor must communicate audit matters of governance interest arising from the audit of financial statements with those charged with governance of an entity. The scope of the ISA is limited to matters that come to the auditor's attention as a result of the audit; the auditors are not required to perform procedures to identify matters of governance interest.

The auditor must determine the relevant persons who are charged with governance and with whom audit matters of governance interest are communicated.

The auditors may communicate with the whole board, the supervisory board or the audit committee depending on the governance structure of the organisation. To avoid misunderstandings, the engagement letter should explain that auditors will only communicate matters that come to their attention as a result of the performance of the audit. It should state that the auditors are not required to design procedures for the purpose of identifying matters of governance interest.

The letter may also do the following:

- **Describe** the **form** which any **communications** on governance matters will take
- **Identify** the **relevant persons** with whom such communications will be made
- **Identify** any **specific matters** of **governance** interest which it has agreed are to be communicated

Matters to be communicated

Matters would include:

The **auditor's responsibilities** in relation to the financial statements	Including that: • the auditor is responsible for forming and expressing an opinion on the financial statements; and • the audit does not relieve management or those charged with governance of their responsibilities.
Planned **scope and timing** of the audit	Including: • how the audit proposes to address the significant risks of material misstatement from fraud or error; • how the auditor plans to address areas of higher assessed risks of material misstatement; • the auditor's approach to internal control; • application of materiality; • the extent to which the auditor will use an auditor's expert; • when ISA 701 applies, the auditor's preliminary views about matters that may be areas of significant auditor attention in the audit and therefore may be key audit matters; and • the auditor's planned approach to significant changes in the applicable reporting framework, environment financial condition or activities. When the auditor is required or decides to communicate key audit matters ISA 260 (Revised) requires that the overview of the planned scope and timing of the audit must also include communicating

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	about the most significant assessed risks of material misstatement identified by the auditor.
Significant findings from the audit	Including: • the auditor's views about accounting policies, accounting estimates and financial statement disclosures; • significant difficulties, if any, encountered during the audit (eg, delays in provision of required information, brief time in which to complete audit, unavailability of expected information); • significant matters arising during the audit that were discussed or subject to correspondence with management; • written representations the auditor is requesting; • circumstances that affect the form and content of the auditor's report; and • other significant matters, including material misstatements or inconsistencies in other information that have been corrected. Entities that are required or choose to report on the application of the UK Corporate Governance Code must communicate to the audit committee information relevant to the board and the audit committee in fulfilling their responsibilities under the Code. For audits of the financial statements of public interest entities the auditor is required to submit an additional report in writing to the audit committee explaining the results of the audit and information including: • a declaration of independence; • identity of key audit partners; • a description of the scope and timing of the audit; • a description of the methodology used; • the quantitative level of materiality applied; • events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; • significant deficiencies in the control system; and • significant difficulties encountered and significant matters arising from the audit.
Auditor independence	In the case of **listed entities** matters include: • a statement that relevant ethical requirements regarding independence have been complied with; • all relationships (including total fees for audit and non-audit services) which may reasonably be thought to bear on independence; and • the related safeguards that have been applied to eliminate/reduce identified threats to independence.

	In the case of public interest entities, the auditor must: • confirm to the audit committee annually in writing that the firm and partners, senior managers and managers, conducting the audit are independent; and • discuss with the audit committee the threats to the auditor's independence and the safeguards applied.

6.1.2 Communication process

The auditor must communicate with those charged with governance the form, timing and expected general content of communications.

The communication process will vary with the circumstances, including:

- the size and governance structure of the entity;
- how those charged with governance operate; and
- the auditor's view of the significance of the matters to be communicated.

For example, reports of relatively minor matters to a small client may be best handled orally via a meeting or telephone conversation.

Before communicating matters with those charged with governance the auditor may discuss them with management, unless that is inappropriate. For example, it would not be appropriate to discuss questions of management's competence or integrity with management.

Written representation should be sought from those charged with governance that explains their reasons for not correcting misstatements brought to their attention by the auditor.

6.1.3 Adequacy of the communication process

The auditor must evaluate whether the two-way communication with those charged with governance has been adequate for the purpose of the audit and, if not, must consider the effect on the assessment of the risks of material misstatement and the ability to obtain sufficient, appropriate evidence.

Interactive question 2: Reporting responsibilities

In each of the cases listed below identify to whom the auditor would initially report.

(1) The auditor has obtained evidence that the operations manager has committed a fraud against the company.

(2) The auditor has obtained evidence that the finance director has committed a fraud against the company.

(3) Disagreement with an accounting policy.

(4) The auditor is suspicious that the board of directors are involved in money laundering activities.

See **Answer** at the end of this chapter.

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6.1.4 Reporting deficiencies in internal control

Auditors may also issue a report on control deficiencies to management. These reports were a key element in your earlier studies in auditing.
ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management* specifies a threshold of significance at which deficiencies in internal control should be communicated to those charged with governance.

Significant deficiencies in internal control are those which, in the auditor's professional judgement, are of sufficient importance to merit the attention of those charged with governance.

Matters that the auditor may consider in deciding whether deficiencies are significant include the following:

- Likelihood of the deficiencies leading to material misstatements in future
- Susceptibility to fraud of related assets and liabilities
- Subjectivity and complexity of determining estimated amounts, such as fair value estimates
- The financial statement amounts exposed to the deficiencies
- The volume of activity in the account balance or class of transactions
- The importance of the controls to the financial reporting process
- The cause and frequency of the exceptions detected
- The interaction of the deficiency with other deficiencies in internal control

Recap of key qualities of a report to management

6.1.4.1 It should not **include language** that **conflicts** with the **opinion** expressed in the audit report.

6.1.4.2 It should state that the **accounting and internal control** system were **considered only** to the **extent necessary** to **determine** the **auditing procedures** to report on the financial statements and not to determine the adequacy of internal control for management purposes or to provide assurances on the accounting and internal control systems.

6.1.4.3 It will state that it **only discusses deficiencies** in internal control which have **come to the auditor's attention** as a result of the **audit** and that other deficiencies in internal control may exist.

6.1.4.4 It should also include a statement that the **communication is provided for use only** by **management** (or another specific named party).

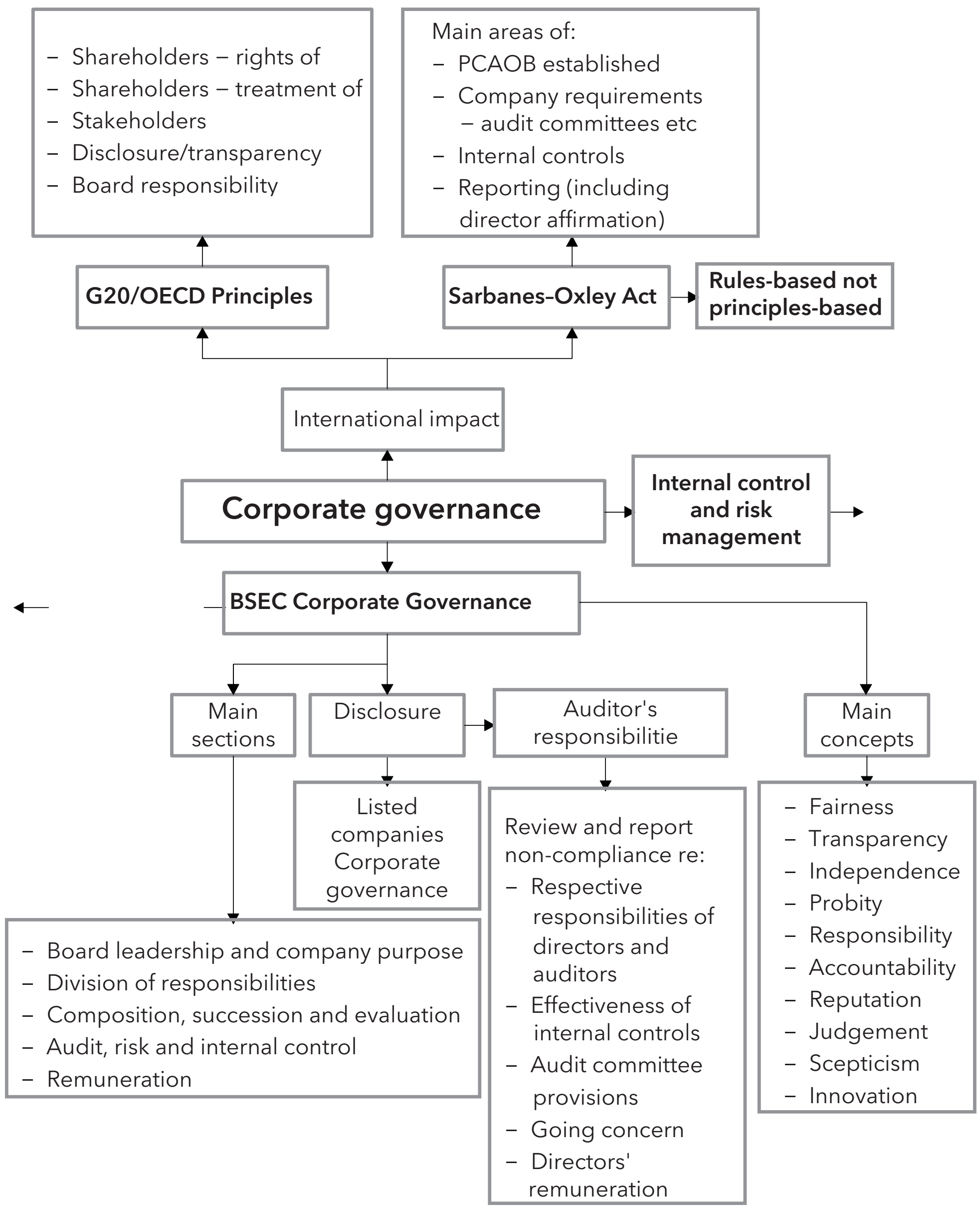
6.1.4.5 The auditors will usually ascertain the actions taken, including the reasons for those suggestions rejected.

6.1.4.6 The auditors may encourage management to respond to the auditor's comments, in which case any response can be included in the report.

Professional skills focus: Concluding, recommending and communicating

The auditor is required to communicate their findings from the course of the audit – it is imperative that the requirements of the standards are followed or the firm could face significant problems.

Summary



CHAPTER 4

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Can you explain what good and bad systems of corporate governance look like?
2.	Can you explain the concepts that underpin sound corporate governance?
3.	Do you understand what the BSEC Corporate Governance Code includes and how it expects companies to apply it? Can you explain how this works in other countries?
4.	Do you understand the various roles played by board members including non-executive directors?
5.	Are you aware of current developments in governance, such as the Stewardship Code, the guidance on risk management and internal control and the various forms of communication required to satisfy best practice?

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
SPV	You may be required to assess the governance practices in place across an organisation, so this question should help you learn how this can be achieved.
Hammond Brothers	Further scenario practice, this time focusing on remuneration issues and matters of a control nature.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios that will help you improve your knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Couvert requirement (2)	Good practice of how governance could be tested in the exam.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving on to the next chapter.

Self-test questions

Answer the following questions.

1 SPV

SPV is listed on the stock exchange of a central European country. The company manufactures a wide range of pharmaceutical products, including modern drugs used in preventing and treating diseases. SPV has three factories where drugs are produced and one research and development facility.

The board of directors comprises the chair/CEO, three executive and two non-executive directors (NEDs). Separate audit and remuneration committees are maintained, although the chair has a seat on both those committees. The NEDs are appointed for two and usually three consecutive four-year terms of office before being required to resign. The internal auditor currently reports to the board (rather than the financial accountant) on a monthly basis, with internal audit reports normally being actioned by the board.

There have recently been problems with the development of a new research and development facility. On a number of occasions the project has fallen behind schedule and the costs have been much greater than expected. Because of developments that have taken place elsewhere in the pharmaceuticals industry while the project was being completed, concern has been expressed that the facility cannot now represent value for money. A couple of large institutional investors have raised concerns about this, and have indicated their intention to raise the issue at the annual AGM and possibly vote against the accounts.

Throughout the project one of the non-executive directors criticised the way the project had been approved and monitored. She claimed that the board had been led by the senior managers in the research and development department and had acted as no more than a rubber stamp for what they wanted to do. She is threatening to resign at the AGM on the grounds that the board is failing to function effectively and she does not wish to be held responsible for decisions on which she has had no effective input. As a result, the other non-executive director has also raised questions about the way the board is functioning.

Requirements

1.1 Explain the main responsibilities of the board, identifying the ways in which SPV's board appears to have failed to fulfil its responsibilities.

1.2 Evaluate the structures for corporate governance within SPV, recommending any amendments you consider necessary to those structures.

2 Hammond Brothers

Hammond Brothers, a road haulage company, is likely to be seeking a stock exchange listing in a few years' time. In preparation for this, the directors are seeking to understand certain key recommendations of the major international corporate governance codes, since they realise that they will have to strengthen their corporate governance arrangements. In particular the directors require information about what the governance reports have achieved in:

- defining the role of non-executive directors;
- improving disclosure in financial accounts;

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- strengthening the role of the auditor; and
- protecting shareholder interests.

Previously the directors have received the majority of their income from the company in the form of salary and have decided salary levels among themselves. They realise that they will have to establish a remuneration committee but are unsure of its role and what it will need to function effectively. The directors have worked together well, if informally; there is a lack of formal reporting and control systems both at the board and lower levels of management. There is also currently no internal audit department.

The directors are considering whether it will be worthwhile to employ a consultant to advise on how the company should be controlled, focusing on the controls with which the board will be most involved.

Requirements

2.1 Explain the purpose and role of the remuneration committee.

2.2 Explain what is meant by organisation and management controls and recommend the main organisation and management controls that Hammond Brothers should operate.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

1.1 **Benefits of the BSEC Corporate Governance Code (the Code) Shareholders**

At its heart, the Code places great emphasis on the importance of sound governance that allows shareholders to assess how well directors have **performed** and what **value** they have created. There are numerous requirements to **engage** with shareholders (such as at formal general meetings or via the senior independent director) and policies such as those related to **remuneration** require alignment with shareholder interests.

Internal controls

Another important area for shareholders is the emphasis placed on directors monitoring and assessing **internal controls** in the business on a regular basis. While it is a statutory requirement that directors safeguard the investment of the shareholders by instituting internal controls, this additional emphasis on quality should increase shareholders' confidence in the business.

Directors' re-election

The requirements of the Code make the **directors more accessible** to the shareholders. They are subject to re-election every year. They are also asked to make disclosure in the financial statements about their responsibilities in relation to preparing financial statements and going concern.

Audit committee

Lastly, some people would argue that the existence of an **audit committee** will lead to shareholders having greater confidence in the reporting process of an entity.

Other users

The key advantage to other users is likely to lie in the increased emphasis on internal controls, as this will assist the company in operating smoothly and increasing visibility of operations, which will be of benefit to customers, suppliers and employees.

1.2 **Voluntary code**

Adherence to the BSEC Corporate Governance Code is not a statutory necessity, although it is possible that in the future such a Code might become part of company law.

Advantages

The key merit of the Code being voluntary for most companies is that it is **flexible**. Companies can review the Code and make use of any aspects which would benefit their business.

If they adopt aspects of the Code, they can disclose to shareholders what is being done to ensure **good corporate governance**, and what aspects of the Code are not being followed, with reasons.

This flexibility is important, for there will be a **cost of implementing** such a Code, and this cost might outweigh the benefit for small or owner-managed businesses.

Disadvantages

Critics would argue that a voluntary code allows companies that should comply with the Code to **get away with non-compliance** unchallenged.

They would also argue that the **type of disclosure** made to shareholders about degrees of compliance could be **confusing and misleading** to shareholders and exacerbate the problems that the Code is trying to guard against.

Answer to Interactive question 2

Initial report

(1) The auditor would report the matter to those charged with governance (ISA 260/240).

(2) The auditor would report the matter to any other member of the board, for example the chief executive or the chair. Where there is doubt about the integrity of those charged with governance as a whole, the auditor will need to seek legal advice as to the appropriate course of action. This may include reporting to third parties eg, police or a regulatory authority (ISA 240).

(3) This would be reported to and discussed with those charged with governance (ISA 260). If the disagreement is material and is not changed, the auditors will also report to the shareholders via the modified opinion in the audit report.

(4) The auditor should report suspicions of money laundering activities to the firm's Money Laundering Compliance Principal (MLCP). The MLCP will then decide on the next appropriate step which may involve making disclosure to the National Crime Agency.

Answers to Self-test questions

1 SPV

1.1 Role of board

Each individual board of directors will take on particular tasks peculiar to their own company and these will be different from company to company. However, there are three key tasks that will be addressed by all boards of directors to one degree or another.

Strategic management

The development of the strategy of the company will almost certainly be led by the board of directors. At the very least they will be responsible for **setting the context for the development of strategy**, defining the nature and focus of the operations of the business and determining the mission statement and values of the business.

Strategic development will also consist of **assessing the opportunities and threats** facing the business, **considering, developing and screening the strategic proposals and selecting and implementing appropriate strategies.** Some or all of this more detailed strategic development may be carried out by the board, but also may be delegated to senior management with board supervision.

In the case of SPV, the board appears to have had inadequate involvement in the development of strategy. While the board may use advice from expert managers, the board should also have challenged what they provided and carried out its own analysis; possible **threats from rivals** appear to have been inadequately considered.

Control

The board of directors is ultimately responsible for the **monitoring and control** of the activities of the company. They are responsible for the financial records of the company and that the financial statements are drawn up using appropriate accounting policies and show a true and fair view. They are also responsible for the **internal controls within the business** that ensure the financial information is accurate and the assets are safeguarded.

The board will also be responsible for the direction of the company and ensuring that the managers and employees work towards the **strategic objectives** that have been set. This can be done by the use of plans, budgets, quality and performance indicators and benchmarking.

Again what has happened with the projects appears to indicate board failings. It seems that the board failed to spot **inadequacies in the accounting information** that managers were receiving about the new project, and did not ensure that **action was taken by managers to control** the overruns in time and the excessive costs that the accounting information may have identified. The board also seems to have failed to identify inadequacies in the information that it was receiving itself.

Shareholder and market relations

The board of directors has an important role externally to the company. The board is responsible for **raising the profile of the company and promoting the company's interests** in its own and possibly other marketplaces.

The board has an important role in managing its relationships with its shareholders. The board is responsible for **maintaining relationships and dialogue** with all shareholders, plus stakeholders as well. As well as the formal dialogue at the AGM many boards of directors have a **variety of informal methods** of keeping shareholders informed of developments and proposals for the company. Methods include informal meetings, company websites, social reports and environmental reports.

The institutional shareholders' intention to vote against the accounts is normally seen as a **last resort** measure, if other methods of exercising their influence and communicating their concerns have failed. This indicates that the board has **failed to communicate effectively** with the institutional shareholders.

1.2 **Suggestions for corporate governance Composition of the board**

Corporate governance requirements normally indicate that the board of directors should comprise equal numbers of executive and non-executive directors. By having only two non-executive directors, SPV may not be following requirements. SPV needs to appoint at least one more non-executive director to the board.

There is also a lack of any recent or relevant financial experience amongst the non-executive directors. Corporate governance regulations normally suggest that at least one NED has financial experience so they can effectively monitor the financial information that the board is reviewing. Making the new appointee an accountant would help to fulfil this requirement.

Role of chair/CEO

Corporate governance regulations normally require that the roles of the chair (the person running the board) and the CEO (the person running the company) are split. The reason for this is to ensure that no one person has too much influence over the running of the company. The roles of chair and CEO at SPV should be split at the earliest opportunity.

Appointment and nomination committee

There does not appear to be a nomination committee for addressing succession and appointment issues. Other issues that are not clear with the current structures relate to the function and composition of SPV's existing committees. Taking the UK Corporate Governance Code as an example, the chair of the board is not normally allowed to sit on the audit committee but they can sit on the remuneration committee provided they are independent and do not chair the committee. SPV needs to ensure that this requirement is being followed.

Service contracts

Service contracts for NEDs should be for a specified term. Any term beyond nine years should be subject to rigorous review and should take into account the need for progressive refreshing of the board. The duration of contracts is limited to ensure that payments for early termination of contracts are not excessive. The reappointment provisions apply to ensure that new NEDs are being appointed as directors on a regular basis. NEDs who have been on the board for a few years may become too familiar with the operations of the company and therefore may not provide the necessary external independent check that they are supposed to do.

Service contracts need to be limited and any over nine years for NEDs (and one year for executives) should be reviewed.

Internal audit

The internal audit department usually does not report to the financial accountant, as that person may have a vested interest in not taking any action on the reports, especially where reports are critical of the accountant. In that sense, reporting to the board is acceptable.

However, the board as a whole may not have the time to review internal audit reports and may be tempted to ignore them if they are critical of the board itself. Corporate governance regulations indicate that the internal audit department should report to the audit committee with reports being forwarded to the board. This ensures that the report is heard by the NEDs, who can then ensure that internal audit recommendations are implemented where appropriate by the board.

In SPV, the internal auditor needs to report to the audit committee, for reasons already mentioned above.

2 Hammond Brothers

2.1 Purpose and role of remuneration committee

The purpose of the remuneration committee is to provide a **mechanism** for **determining** the **remuneration packages** of executive directors. The scope of the review should include not only salaries and bonuses, but also share options, pension rights and compensation for loss of office.

The committee's remit may also include issues such as **director appointments** and succession planning, as these are connected with remuneration levels.

Constitution of remuneration committee

Most codes recommend that the remuneration committee should consist entirely of **non-executive directors** with no personal financial interest other than as shareholders in the matters to be decided. In addition, there should be **no conflict of interests** arising from remuneration committee members and executive directors holding directorships in common in other companies. Within Hammond, there is a requirement to first appoint NEDs and then ensure that the remuneration committee is comprised of these individuals. The current system of the directors deciding their own salary is clearly inappropriate; there is no independent check on whether the salary levels are appropriate for the level of experience of the directors or their salary compared with other similar companies.

Functioning of remuneration committee

The UK Corporate Governance Code recommends that remuneration policy should be long term in nature and clearly linked to the successful delivery of strategy. The committee should pay particular attention to the setting of performance-related elements of remuneration.

Within Hammond, the vast majority of remuneration is based on salary; there is little element of performance-related pay. Governance guidelines indicate that remuneration should be balanced between basic salary and bonuses. Hammond's remuneration committee needs to increase the bonus element of remuneration to focus directors more onto improving the performance of the company. However, conditions for receipt of performance-related remuneration should be designed to promote the long-term success of the company.

Consideration should be given to the possibility of reclaiming variable components in exceptional circumstances of misstatement or misconduct.

Reporting of remuneration committee

A **description** of the work of this committee should form part of the annual report. This description should set out **company policy** on remuneration and give details of the **packages** for **individual directors** and their **rationale**. The report should describe the extent (if any) of **shareholder engagement** with the company's remuneration policy and **workforce engagement** about how executive remuneration is aligned with the wider company pay policy.

2.2 Main concerns of board

The board's principal concern is with controls that can be classified as organisation or management.

Organisation controls

Organisation controls are designed to ensure **everyone** is **aware** of their **responsibilities**, and **provide** a **framework** within which lower level controls can operate. Key organisation controls include the following.

(1) **Structure**

The board should establish an **appropriate structure** for the organisation and **delegate** appropriate levels of authority to different grades.

(2) **Internal accounting system**

The board should ensure that the system is providing **accurate and relevant information** on a regular basis. Good quality information will enable the board to assess whether targets are being met or losses are possible.

(3) **Communication**

Communication of organisation **policies** and values through manuals and other guidance to staff is essential. It is not clear from the scenario whether Hammond actually has any of these controls in place; however, from the relatively informal basis in which the company has been run, it is unlikely that detailed controls have been implemented.

Management controls

Management controls are designed to **ensur**e that the **business** can be **effectively monitored**. Key management controls include the following.

(1) **Monitoring of business risks on a regular basis**

This should include **assessment of the potential financial impact** of contingencies.

(2) **Monitoring of financial information**

Management should be alert for significant variations in results between branches or divisions or significant changes in results.

(3) **Use of audit committee**

The committee should actively **liaise** with the external and internal auditors, and **report** on any deficiencies discovered. The committee should also regularly **review** the **overall structure** of internal control, and investigate any serious deficiencies found.

(4) **Use of internal audit**

Internal audit should be used as an independent check on the operation of detailed controls in the operating departments. Internal audit's work can be targeted as appropriate towards areas of the business where there is a risk of significant loss should controls fail. As there is no internal audit department at present, the board will need to establish one and define its remit.

The overall lack of controls is concerning, given the objective to obtain a listing. The directors will need to implement the recommendations of the UK Corporate Governance Code to ensure that a listing can be obtained.

Chapter 5

The statutory audit: planning and risk assessment

Introduction

Learning outcomes

- Evaluate and explain current and emerging issues in auditing including developments in the use of technology (eg, impact of Task Force on Climate-related Financial disclosures, big data, data analytics and artificial intelligence)
- Identify the components of risk and how these components may interrelate
- Appraise the entity and the, potentially complex, economic environment within which it operates as a means of identifying and evaluating the risk of material misstatement
- Identify and appraise the risks, including analysing qualitative and quantitative data using data analytics software, arising from, or affecting, a potentially complex set of business processes and circumstances and assess their implications for the engagement
- Identify significant business risks (including those arising from cyber security and technological advances including cloud computing, cryptocurrencies and robotic process automation) and assess their potential impact upon the financial statements and the audit engagement
- Evaluate the impact of risk and materiality in preparing the audit plan, for example the nature, timing and extent of audit procedures
- Evaluate the components of audit risk for a specified scenario using data analytics software when appropriate, including the interactions of inherent risk, control risk and detection risk, considering their complementary and compensatory nature
- Interrogate an organisation's accounting records using data analytics software to identify audit risks and communicate with the audit team
- Show professional scepticism in assessing the risk of material misstatement, having regard to the reliability of management
- Develop and appraise, based upon planning procedures, an appropriate audit strategy and detailed audit plan or extracts
- Analyse and evaluate the control environment for an entity based on an understanding of the entity, its operations and its processes
- Evaluate an entity's processes for identifying, assessing and responding to business and operating risks as they impact on the financial statements
- Explain and evaluate the relationship between audit risk and audit evidence

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	**Overview of the audit process**	**Approach** Use the diagram to	This diagram will help you to remember where	N/A

	A quick reminder of the various stages of the audit so you can track your progress through this part of the Workbook.	introduce the rest of this chapter. **Stop and think** How much of this do you remember from your previous auditing studies?	you are in the audit process and what (if anything) you may still require for successful completion.	
2	**Audit planning** An overview of the key auditing standards that are used during planning.	**Approach** Confirm your understanding of these standards by reference to the diagram in the previous section. **Stop and think** Can you find these standards in your auditing standards open book?	Many questions are set at the planning stage of the audit so it's important you can apply the standards to the scenario if required.	N/a
3	**Professional scepticism** The role and importance of professional scepticism has grown in recent years, following a number of high profile corporate casualties.	**Approach** Compare this section with the definitions of professional scepticism that you will find in both ISA 200 and the Glossary at the back of the auditing standards open book. **Stop and think** Consider which parts of the audit are most likely to require the greatest amounts of professional scepticism.	You can expect to see scenarios that will require you to display professional scepticism when analysing the key issues.	N/A
4	**Understanding the entity** You need to understand an entity properly in order to be able to assess risks of misstatements within the financial statements effectively.	**Approach** Through reading both this section and the contents of ISA 315, you should be able to start identifying issues that could lead to some form of misstatement. Note how various	This section demonstrates the need to treat all information in a given scenario holistically in order to build a fuller picture of the entity and all the risks it presents.	N/A

		industries and processes affect your understanding. **Stop and think** Use the worked example to see this working in practice.		
5	**Business risk model** As well as being part of sound governance, business risks can be used to understand the areas of the financial statements at greatest risk of being misstated.	**Approach** Consider business risks and how they could impact on the financial statements. **Stop and think** Can you explain why this is not the same as audit risk but can still be helpful when identifying areas of audit risk?	You will need to be on the lookout for various situations that could create misstatement of some kind.	**IQ1: Financial risk** A short illustration of the connection between these two types of risk. **IQ2: Audit procedures** Great practice for interrogating a scenario and considering the implications of your findings. **IQ3: Identifying business risk** Further practice of how the business risk approach is used to consider the impact of certain business issues on the audit.
6	**Audit risk** A comprehensive background of the elements that go into the assessment of audit risk.	**Approach** Review this content with your previous studies in mind and focus on how you would apply this knowledge in a more complex scenario. **Stop and think** Note how practical the approaches in this section are.	You may find it helpful to consider the separate components of audit risk (inherent, control and detection) in structuring your answer.	**IQ4: Inherent risks from financial reporting policies** A useful starting point in explaining inherent risk. **IQ5: Audit risk** A more detailed scenario which will help you understand how to identify and explain audit risks in an exam situation.
7	**Creative accounting** This is one of the bigger risks that can have a significant effect on a set of financial statements,	**Approach** Consider each of the causes and consequences of creative accounting.	Taking the list of red flags as an example, you should be prepared to look for illustrations of these factors in a scenario	N/A

	yet it can also be one of the hardest to detect.	**Stop and think** Note how a strong sense of professional scepticism would help identify cases of creative accounting.	as they are likely to have been inserted specifically for the purpose of implying that there is something more sinister buried.	
8	**Materiality** This is what gives the auditor an indication of the things that really matter, both at planning and in subsequent parts of the audit. Remember that it is not always a number that determines materiality!	**Approach** This section is largely revision from your previous auditing studies but still requires your attention. **Stop and think** Note the levels of materiality used in some of the worked examples.	While you can always calculate the materiality levels to be used in an exam question based on certain thresholds, don't forget the specific circumstances in the scenario that could mean other items are still worthy of your audit focus.	**IQ6: Materiality (1)** An assessment of your ability to calculate the appropriate level of materiality. **IQ7: Materiality (2)** A more complex example of the amount that should be used to determine materiality.
9	**Responding to assessed risks** Once audit risk has been assessed, the auditor needs to decide what to do next.	**Approach** Make sure you can differentiate between risks that affect the financial statements overall and those at the assertion level only. **Stop and think** You will need to consider the evidence required from this evaluation.	Make sure you consider audit procedures that are suitable and based on the assessed risks.	N/A
10	**Other audit methodologies** In addition to the risk methodologies covered in this chapter, there are other approaches that the auditor can use.	**Approach** Work through each of these three audit methodologies. **Stop and think** Can you remember which methodologies support substantive testing as opposed to testing controls?	You should be prepared to consider a variety of audit approaches and must be led by the detail provided in the scenario.	N/A

11	**Information technology and risk assessment** Most organisations rely on some form of information technology to support their business operations. It is essential that auditors factor this into their audit planning.	**Approach** Review the content in this section paying particular attention to the terminology used. **Stop and think** Are there elements of this technology that you or your employer make use of?	Questions in this area tend to require that you advise a client on something of a technical nature, so it is essential that you can identify what the technology is and how it should be used, being alert to the advantages and disadvantages.	N/A
12	**Big data** This is another area of significant importance for auditors and their clients.	**Approach** Consider the different Vs of big data. **Stop and think** Make sure that you can explain what big data is and how it could be used in an entity.	Again, you are most likely to need to explain the opportunities, benefits and drawbacks of big data in an advisory capacity.	N/A
13	**Data analytics, robotic process automation (RPA) and artificial intelligence (AI)** Technology is fast becoming the next frontier for auditors as business processes are increasingly becoming more automated. Audit quality is the ultimate winner but it requires significant investment to reap the promised benefits.	**Approach** Once you have read this section, start to consider how technology could improve the audit but at the same time, what risks the use of technology might also bring. **Stop and think** How can you use technology to improve the quality of the audit?	This is becoming an increasingly challenging area to examine as the pace of change is relentless. However, you should consider the use of technology in the audit (especially data analytics software) and how it can be leveraged to improve audit quality.	N/A

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Overview of the audit process

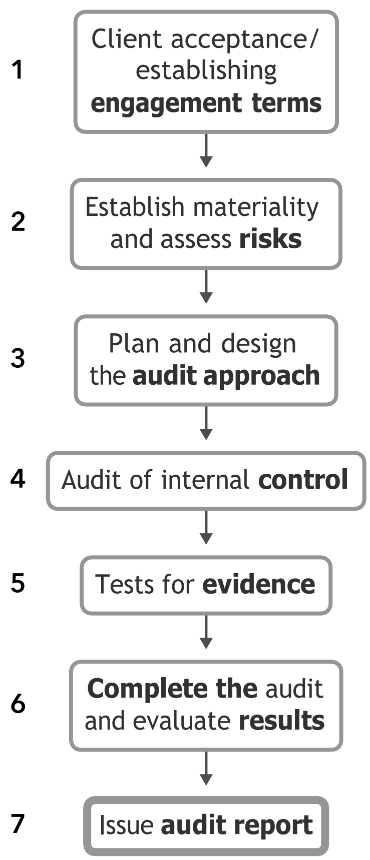
Section overview

The audit is designed to enable the auditor to obtain sufficient, appropriate evidence.

1.1 Overview

While there may be variations between specific procedures adopted by individual firms, the audit process as set out in auditing standards is a well-defined methodology designed to enable the auditor to obtain sufficient, appropriate evidence.

This process can be summarised in a number of key stages: Figure 5.1: Summary of audit process



In this chapter we will consider stages 1 to 4. In Chapter 6 we will consider stage 5, and in Chapter 8, stages 6 and 7. However, it is important not to view the audit as a series of discrete stages and individual audit procedures. For example, it can be argued that all audit procedures which provide evidence are risk assessment procedures whether they are conducted during planning, control evaluation, substantive testing or completion. The audit process will adopt a strategy where complementary evidence is acquired and evaluated from a range of sources. The process is repeated until the auditor has obtained sufficient, appropriate audit evidence which is adequate to form an opinion.

2 Audit planning

Section overview

You should be familiar with the basic planning process

2.1 Introduction

Auditors are required to plan their work to ensure that attention is paid to the correct areas of the audit, and the work is carried out in an effective manner.

In order to produce this plan the auditor must do the following:

- Understand the business, its control environment, its control procedures and its accounting system
- Assess the risk of material misstatement
- Determine materiality
- Develop an audit strategy setting out in general terms how the audit is to be carried out and the type of approach to be adopted
- Produce an audit plan which details specific procedures to be carried out to implement the strategy taking into account all the evidence and information collected to date

You have already covered planning and risk assessment issues in your earlier studies. The relevant ISAs are:

- ISA 210 (, *Agreeing the Terms of Audit Engagements*
- ISA 300, *Planning an Audit of Financial Statements*
- ISA 315, *Identifying and Assessing the Risks of Material Misstatement*
- ISA 320, *Materiality in Planning and Performing an Audit*
- ISA 330, *The Auditor's Responses to Assessed Risks*

A number of issues are developed in the remainder of this chapter; however, it is assumed that you are already familiar with the basic principles of planning and risk assessment. A summary of these and other related ISAs can be found in the technical reference section at the end of the chapter.

3 Professional scepticism

Section overview

The auditor must maintain an attitude of professional scepticism throughout the audit.

3.1 Requirement

Definition

Professional scepticism: An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

Professional scepticism includes being alert to:

- audit evidence that contradicts other audit evidence;
- information that brings into question the reliability of documents and responses to enquiries to be used as audit evidence;
- conditions that may indicate possible fraud; and
- circumstances that suggest the need for audit procedures in addition to those required by the ISAs.

ISA 200, *Overall Objectives of The Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing* requires that the auditor 'shall plan and perform an audit with professional scepticism recognising that circumstances may exist that cause the financial statements to be materially misstated'. Maintaining professional scepticism throughout the audit reduces the risks of overlooking unusual circumstances, overgeneralising when drawing conclusions and using inappropriate assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results. ISA 200 also makes the following points:

(a) The auditor may accept records and documents as genuine unless there is reason to believe the contrary. Where there is doubt, for example where there are indications of possible fraud, the auditor must investigate further and determine whether to modify or increase the audit procedures.

(b) A belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional scepticism.

The same points are reiterated in ISA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements. This standard emphasises that where there are potential fraud issues the auditor's professional scepticism is particularly important when considering the risks of material misstatement.

3.2 Importance of professional scepticism

The importance of professional scepticism cannot be overemphasised. An effective and compliant audit cannot be carried out without it.

Given that it is fundamental that professional scepticism is applied for all audits of financial statements, the audit engagement partners of audit firms must lead by example and firms should ensure that professional scepticism is given the degree of prominence it warrants during the training of audit staff.

Following the global financial crisis in 2008 and 2009 a common theme in a number of regulator reports was that professional scepticism could have been more clearly demonstrated by auditors when looking at a number of audit areas. It continues to be at the top of the agenda for regulators and standard setters, including the IAASB in their 2018 update of the IESBA Code of Ethics as well as the UK FRC, whose response to this 2018 update cited the need for 'a global debate to focus on what actions, key characteristics and behaviours are required on the part of a practitioner to ensure the application of appropriate professional scepticism in a way that will meet the expectations of users of information' (UK FRC, 2018).

This section has dealt with the theoretical background of professional scepticism and the use of professional scepticism in an audit planning context. We will look at professional scepticism again in the more practical context of audit fieldwork in Chapter 6.

4 Understanding the entity

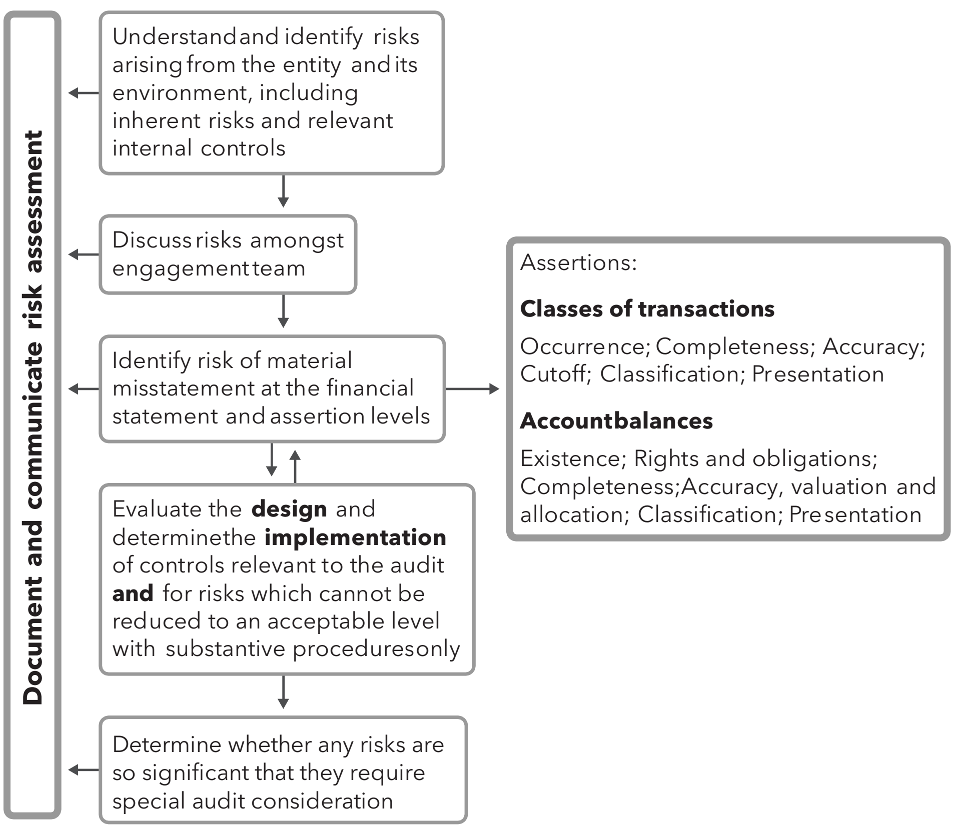
Section overview

- The auditor obtains an understanding of the entity in order to assess the risks of material misstatement.
- Information will be sought regarding the industry in which the business operates and the different business processes within the entity itself.
- Auditors should be aware of the concept of scalability when assessing risk for entities of different sizes and complexities.

4.1 Procedures

ISA 315, *Identifying and Assessing the Risks of Material Misstatement* paragraph 11 states that: “the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement”.

Figure 5.2: Audit risk assessment



(Source: ICAEW Audit and Assurance Faculty (2004) *Auditing Standards – All Change: A Short Guide to Selected International Standards on Auditing (UK and Ireland) adapted for standards updated since 2004*)

You will have studied the financial statement assertions in your earlier studies and you will find a more detailed recap including changes resulting from the June 2016 revised standards in Chapter 6.

ISA 315 sets out various methods by which the auditors may obtain this understanding as part of their risk assessment:

- **Enquiries of management** and others within the entity (including internal audit if appropriate)
- **Analytical procedures**
- **Observation** and **inspection**
- Audit team **discussion** of the applicable financial reporting framework and the susceptibility of the financial statements to material misstatement
- **Prior period knowledge** (subject to certain requirements) and engagement-specific matters related to acceptance and continuance

The auditors must use a combination of the top three techniques, and must engage in discussion for every audit. The auditor may use their prior period knowledge, but must carry out procedures to ensure that there have not been changes in the year meaning that it is no longer valid.

The ISA sets out a number of areas of the entity and its environment that the auditor should gain an understanding of. These are summarised as follows:

- Industry, regulatory and other external factors
- Nature of the entity
- The applicable financial reporting framework and the entity's selection and application of accounting policies, including reasons for any changes
- Measurement and review of the company's performance
- Inherent risk factors and the impact they have at both assertion and financial statement level
- Internal control relevant to the audit

The purpose of obtaining the understanding is to **assess the risks of material misstatement** in the financial statements for the current audit. The ISA says that the auditor shall identify and assess the risks of material misstatement at the financial statement level, and in line with ISA 330 (effectively responding to assessed risks at the assertion level).

The approach that the auditor is required to take can be summarised by the following steps:

Step 1 Identify risks throughout the process of obtaining an understanding of the entity Evaluate

Step 2 whether the risks relate pervasively to the financial statements as a whole Relate the risks to

Step 3 what can go wrong at the assertion level

Step 4 Consider the likelihood of misstatement (including the possibility of multiple misstatements)

Step 5 Consider the likelihood of the risks causing a material misstatement

Context example: Ockey Ltd

The audit team at Ockey Ltd has been carrying out procedures to obtain an understanding of the entity. In the course of making enquiries about the inventory system, they have discovered that Ockey Ltd designs and produces tableware to order for a number of high street stores. It also makes a number of standard lines of tableware, which it sells to wholesalers. By the terms of its contracts with the high street stores, it is not entitled to sell unsold inventory designed for them to wholesalers. Ockey Ltd regularly produces 10% more than the high street stores have ordered, in order to ensure that they meet requirements when the stores do their quality control check. Certain stores have more stringent control requirements than others and regularly reject some of the inventory.

The knowledge above suggests two risks, one that the company may have obsolescent inventory, and another that if its production quality standards are insufficiently high, it could run the risk of losing custom.

We shall look at each of these risks in turn and relate them to the assertion level.

Inventory

If certain items of the inventory are obsolescent due to the fact that it has been produced in excess of the customer's requirement and there is no other available market for the inventory, then there is a risk that inventory as a whole in the financial statements will not be carried at the appropriate value. Given that inventory is likely to be a material balance in the statement of financial position of a manufacturing company, and the value could be up to 10% of the total value, this has the capacity to be a material misstatement.

The factors that will contribute to the likelihood of these risks causing a misstatement are matters such as:

- whether management regularly review inventory levels and scrap items that are obsolescent;
- whether such items are identified and scrapped at the inventory count; or
- whether such items can be put back into production and changed so that they are saleable.

Losing custom

The long-term risk of losing custom is that in the future the company will not be able to operate (a going concern risk). It could have an impact on the financial statements, if sales were disputed, revenue and receivables could be overstated; that is, not carried at the correct value. However, it appears less likely that this would be a material problem in either area, as the problem is likely to be restricted to a few customers, and only a few sales to those customers.

Again, review of the company's controls over the recording of sales and the debt collection procedures of the company would indicate how likely these risks to the financial statements are to materialise.

Some risks identified may be **significant risks** (indicated by the following factors), in which case they present **special audit considerations** for the auditors:

- Risk of **fraud**
- Its relationship with **recent developments**
- The degree of **subjectivity** in the financial information
- The fact that it is an **unusual** transaction
- It is a significant transaction with a **related party**
- The **complexity** of the transaction

Routine, non-complex transactions are less likely to give rise to significant risk than unusual transactions or matters of director judgement because the latter are likely to have more management intervention, complex accounting principles or calculations, greater manual intervention or lower opportunity for control procedures to be followed.

When auditors identify a significant risk, if they have not done so already, they should evaluate the design and implementation of the entity's controls in that area.

4.2 Industries and processes

During the initial planning phase, the audit firm will need to obtain information about the specific nature of the entity being audited and the different business processes within the entity itself.

4.2.1 Industry

The type of entity being audited will have a significant impact on the audit plan. For example:

Service industry	Manufacturing industry
Little or no inventory	Complex costing systems to allocate costs to inventory and work in progress
Focus on salaried employees	Many production staff based paid on hours worked including various overtime and incentive schemes
Payment by commission	May have payment by piece rates
Sales dependent on services provided	Sales dependent on products sold
Relatively little investment in plant and equipment; office space main building cost	Large investment in plant and equipment; office space relatively small in comparison to production facilities

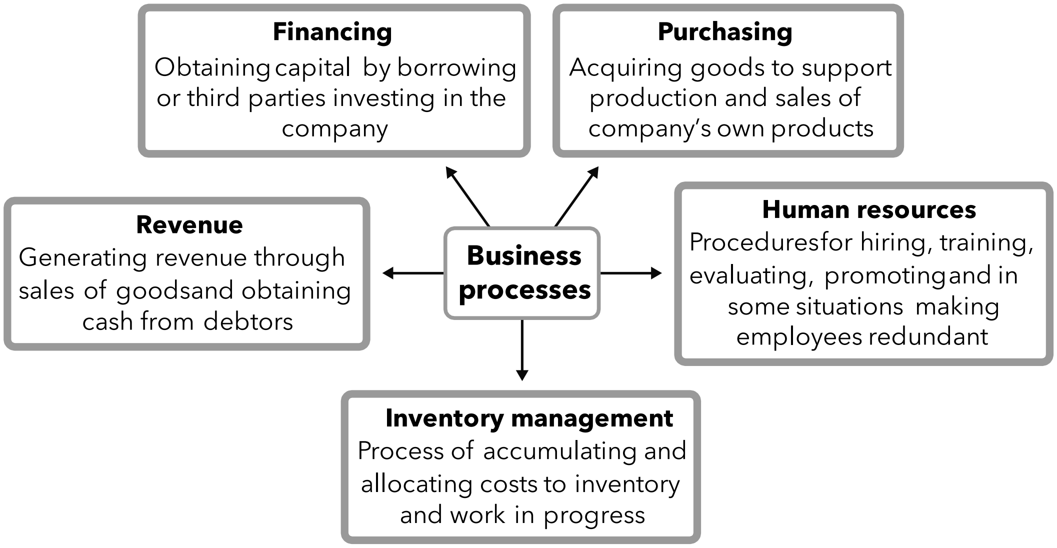
An understanding and appreciation of these differences will assist the auditor in identifying risk areas and in developing an appropriate audit approach.

From the auditor's point of view, the different entities will result in a different audit approach for each entity. For example, the lack of inventory in service industries will obviously mean less time will be devoted to that area. Conversely, the use of complicated costing systems will require use of specialist computer-auditors to identify, record and test various computerised systems.

4.2.2 Business processes

From the comments above, it is possible to identify the different business processes that the auditor will need to focus on. The five main processes are summarised in the diagram below.

Figure 5.3: Business processes



An understanding of each process focuses the auditor's attention on specific parts of the business.

Process	Audit focus
Financing	Verification of new share issues / confirming current account and loan balances and where necessary bank support for the business.
Purchasing	Audit of the purchases transaction cycle and payables balance.
Human resources	Audit of wages and salaries, including bonuses linked to production and commission on sales.
Inventory management	Audit of work in progress systems, including year-end inventory valuation and identification of inventory below cost price.
Revenue	Audit of sales transaction cycle and receivables balance.

The actual audit approach will depend partly on the audit methodology used.

Professional skills focus: Assimilating and using information

Scenarios are usually long and complex but will usually contain all the information you require to evaluate audit risk. Understanding the entity is therefore a process that takes time to master, but eventually helps you build up a better overall view of an organisation.

4.3 Scalability

ISA 315 reminds auditors of the concept of scalability.

Definition

Scalability: Auditors should apply the requirements of an ISA to all entities regardless of their complexity, nature and circumstances.

What this means is that ISA 315 should be applied to all entities regardless of their size or complexity – small entities with poor systems of control might still be complex and therefore risky, while larger entities with robust systems of internal control might actually be considered less risky.

There should be no preconceptions.

4.4 Standing back

In line with other ISAs there is also a need for the auditor to constantly assess the evidence that is being uncovered as the audit engagement unfolds: should this indicate contradictory to initial assessments, suitable action should be taken, either escalating or diminishing audit effort as appropriate, on an iterative basis.

5 Business risk model

Section overview

- Business risk is the risk arising to the business that it will not achieve its objectives.
- Corporate governance guidelines emphasise the importance of risk management processes within a business.
- The business risk model of auditing requires the auditor to consider the entity's process of assessing business risk and the impact this might have in terms of material misstatement.

5.1 Business risk

Business risk is the risk arising to entities that they will not achieve their objectives. It includes risks at all levels of the business.

Business risks can be classified into three categories.

(a) **Financial risks**

(b) **Operating risks**

(c) **Compliance risks**

Definitions

Financial risks: Risks arising from the company's financial activities (eg, investment risks) or the financial consequences of operations (eg, receivables risks).

Examples: going concern, market risk, overtrading, credit risk, interest rate risk, currency risk, cost of capital, treasury risks.

Operating risks: Risks arising from the operations of the business.

Examples: loss of orders; loss of key personnel; physical damage to assets; poor brand management; technological change; stock-outs; business processes unaligned to objectives.

Compliance risks: Risks arising from non-compliance with laws, regulations, policies, procedures and contracts.

Examples: breach of company law, non-compliance with accounting standards; listing rules; taxation; health and safety; environmental regulations; litigation risk against client.

The fundamental structure governing data protection and privacy is established by the constitutional rights to privacy in Bangladesh, as outlined in the Constitution, alongside the Information Communication Technology Act of 2006 and the Digital

Security Act of 2018. The ICT Guidelines, read with the Bank Companies Act, impose an obligation on the banks to ensure that their data are stored within the geographical limits of Bangladesh.

The UK's adoption of the General Data Protection Regulation as part of EU law could also be included here, although compliance is just as important for auditors as it is for their clients.

Business risk may be caused by many factors, or a combination of factors, including the following:

- Complex environment
- Dynamic environment
- Competitors' actions
- Inappropriate strategic decision-making
- Operating gearing
- Financial gearing
- Lack of diversification
- Susceptibility to currency fluctuations
- Inadequate actual or contingent financial resources
- Dependence on one or few customers
- Regulatory change or violation
- Adequacy and reliability of suppliers
- Overtrading
- Developing inappropriate technology
- Macroeconomic instability
- Poor management

5.2 Business risk management

Most working environments now have some form of risk management system. In Chapter 4 we discussed the Corporate Governance Code and the *Guidance on risk management, internal control and related financial and business reporting* that highlight its importance. Typically, the process of risk management for the business is as follows:

- Identify significant risks which could prevent the business achieving its objectives
- Provide a framework to ensure that the business can meet its objectives
- Review the objectives and framework regularly to ensure that objectives are met

In practice, each of these stages is complex

5.3 Audit methodology: business risk model

5.3.1 Principle behind the model

ISA 315 requires that auditors consider the **entity's process for assessing its own business risks**, and the impact that this might have on the audit in terms of material misstatements. Auditors consider the following:

- What factors lead to the problems which may cause material misstatements
- What the audit can contribute to the business pursuing its goals

The business risk audit approach tries to mirror the risk management steps that have been taken by the directors. In this way, the auditor will seek to establish that the financial statement objectives have been met, through an investigation into whether all the other business objectives have been met by the directors.

The application of the business risk model (BRM) is therefore related to the client's:

- objectives
- business strategy
- risk management procedures
- industry environment
- economic environment

This approach to the audit has been called a **top down approach** because it starts with the business and its objectives and works back down to the financial statements, rather than working up from the financial statements which has historically been the approach to audit involving detailed tests of transactions and balances. The BRM therefore looks at the 'big risks' that may significantly threaten the valuation, profitability or even the going concern of the business. Those who support this approach argue that the key audit risks are more likely to relate to the failure of the company's strategy than the misstatement of a transaction.

The following table demonstrates the way in which business risks can have implications for the financial statements and therefore the audit.

Principal risk	Immediate Financial Statement implications
Economic pressures causing reduced unit sales and eroding margins	Inventory values (IAS 2) Going concern
Economic pressures resulting in demands for extended credit	Receivables recoverability
Product quality issues related to inadequate control over supply chain and transportation damage	Inventory values – net realisable value and inventory returns
Customer dissatisfaction related to inability to meet order requirements	Going concern
Customer dissatisfaction related to invoicing errors and transportation damage	Receivables valuation
Unacceptable service response call rate related to poor product quality	Going concern Litigation – provisions and contingencies Inventories – net realisable value
Out of date IT systems affecting management's ability to make informed decisions	Anywhere
Extensive use of freelance and contract labour resulting in issues regarding their employment status	Employees' NI (may be understated if freelancers/contract workers are deemed to be employees) Fines – provisions and contingencies

Interactive question 1: Financial risk

On 1 January 20X8 a steel production company has significant steel inventories with a total value of £20 million.

To protect the inventory from changes in value, the entity enters into a futures contract on a commodities exchange to fix the selling price in 18 months' time. This is the first time that the entity has entered into this type of transaction.

Requirements

1.1 Identify the business risk in this situation.

1.2 Identify the issues which the auditor would need to consider. See **Answer** at the end of this chapter.

5.3.2 Impact on audit procedures

This can be summarised as follows:

Audit procedure	Effect of business risk model
Tests of controls	As the auditor pays greater attention to the high level controls used by directors to manage business risks, controls testing will be focused on items such as the control environment and corporate governance rather than the detailed procedural controls tested under traditional approaches.
Analytical procedures	Analytical procedures are used more heavily in a business risk approach, as they are consistent with the auditor's desire to understand the entity's business rather than to prove the figures in the financial statements.
Detailed testing	The combination of the above two factors, particularly the higher use of analytical procedures, will result in a lower requirement for detailed testing, although substantive testing will not be eliminated completely.

Interactive question 2: Audit procedures

You are using the business risk model in the statutory audit of a major international pharmaceutical company.

You are told that the key determinant of profitability is the development of new types of drug, which are superior to those of competitors. This is achieved by significant investment in research and development (R&D). However, you are also informed that such drugs may take as many as 10 years before gaining regulatory approval for use. One major R&D project is a joint venture with another pharmaceutical company.

Requirement

Outline:

(1) the key risks facing the company

(2) controls that management might use to mitigate such risks

(3) audit procedures to be carried out in respect of such risks

See **Answer** at the end of this chapter.

Interactive question 3: Identifying business risks

KidsStuff Ltd imports children's toys from a supplier in the Far East into its warehouse in Liverpool and distributes them to retailers throughout the UK. The company was set up by Joseph Cooper 40 years ago and is managed by Joseph and his two sons. The company had experienced reasonable growth until the last five years, but recent performance has been poor and the company now relies on a substantial overdraft. Joseph feels that the decline is due in part to the competitiveness of the market and the trend towards computer games. KidsStuff Ltd does not have a strong market presence in this area but this is currently being addressed by Joseph's son, Neil, who is confident that performance has improved.

You have received the following email from the engagement partner.

To: Audrey Senior

From: Allan Partner

Subject: KidsStuff Ltd

I know you are about to start work on your planning of this audit. Can you make sure that you specifically identify the business risks faced by KidsStuff Ltd and set out the effect of those on the audit. Can you also make a list of the further information you need in order to plan the audit so that I can request it from the directors?

Requirement

Respond to the engagement partner's email. See **Answer** at the end of this chapter.

6 Audit risk

Section overview

- Audit risk is the risk that the auditors may give an inappropriate opinion when the financial statements are materially misstated and consists of risks of material misstatement and detection risk.
- Risks of material misstatement can exist at both financial statement level and assertion level.
- The risk of material misstatement at the assertion level is made up of inherent risk and control risk.
- Inherent risk factors can include complexity, subjectivity, change, uncertainty or susceptibility to misstatement due to management bias and/or fraud.
- Information gained in obtaining an understanding of the business is used to assess risk.
- Assessment of control risk involves assessing an entity's system of internal control which consists of the control environment, the entity's risk assessment process, the entity's process for monitoring the system of internal control, information systems and communication, control activities and limitations of internal control.

6.1 Audit risk

Definitions

Audit risk: The risk that auditors may give an inappropriate audit opinion when the financial statements are materially misstated. Audit risk has two key components: **risks of material misstatement** in the financial statements and the risk of the auditor not detecting material misstatements in the financial statements (**detection risk**).

Risks of material misstatement: According to ISA 200, risks of material misstatement exist at two levels: the overall **financial statement level** (affecting many assertions) and the **assertion level** for classes of transactions, account balances and disclosures. Risks of material misstatement at the assertion level consist of **inherent risk** and **control risk**.

Inherent risk: The **susceptibility** of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

Control risk: The risk that a misstatement could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, **will not be prevented, or detected and corrected**, on a timely basis by the entity's system of internal control.

Detection risk: The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level **will not detect a misstatement** that exists and that could be material, either individually or when aggregated with other misstatements.

6.1.1 The financial statement level

There are a number of factors which ISA 315 (Revised) discusses that could generate risks of material misstatement at the financial statement level. Here are some examples, including the impact that each could have on the conduct of the audit:

- **Operating losses** and **liquidity problems** which could affect the going concern status of the entity
- **Deficiencies in the entity's system of internal control** which may lead the auditor to conclude that there are questions around management integrity
- **Adverse economic conditions** that could lead to the need for additional financing (this could in turn lead to greater risk of material misstatement at the assertion level in areas susceptible to manipulation of key areas of the financial statements, such as assets, revenue and liabilities)
- Concerns about **changes to information systems** could increase the risks of material misstatement when considering the reliance to be placed upon the entity's accounting records (ISA 315 : paras. A195-199)

6.1.2 Inherent risk

ISA 315 Appendix 2 lists a series of inherent risk factors that indicate susceptibility to misstatement before the consideration of any controls. They relate to the preparation of information required by the applicable financial reporting framework and are listed below.

- Complexity
- Subjectivity
- Change
- Uncertainty
- Susceptibility to misstatement due to management bias or fraud

The susceptibility of any item prone to misstatement needs to be assessed by the auditor and this will be undertaken in terms of **likelihood** and **magnitude**, placing such items on what is called the **spectrum of inherent risk**. Items placed towards the higher end of this spectrum will be considered **significant risks** and will therefore demand more of the auditor's time and attention.

Inherent risk is the risk that items will be misstated due to characteristics of those items, such as the fact they are estimates and that they are important items in the accounts. The auditors must use their **professional judgement** and the **understanding of the entity** they have gained to assess inherent risk. If no such information or knowledge is available then the inherent risk is **high**.

Factors affecting client as a whole	
Integrity and **attitude to risk** of directors and management	Domination by a single individual can cause problems
Management experience and **knowledge**	Changes in management and quality of financial management
Unusual pressures on management	Examples include tight reporting deadlines, or market or financing expectations
Nature of business	Potential problems include technological obsolescence or overdependence on single product
Industry factors	Competitive conditions, regulatory requirements, technological developments, changes in customer demand
Information technology	Problems include lack of supporting documentation, concentration of expertise in a few people, potential for unauthorised access

Factors affecting individual account balances or transactions	
Financial statement accounts **prone to misstatement**	Accounts which require adjustment in previous period or require high degree of estimation
Complex or **subjective** accounts	Accounts which require expert valuations or are subjects of current professional discussion

Factors affecting individual account balances or transactions	
Assets at risk of being **lost** or **stolen**	Cash, inventory, portable non-current assets (computers)
Quality of **accounting systems**	Strength of individual departments (sales, purchases, cash etc)
High **volume** transactions	Accounting system may have problems coping

Unusual transactions	Transactions for large amounts, with unusual names, not settled promptly (particularly important if they occur at period end) Transactions that do not go through the system, that relate to specific clients or are processed by certain individuals
Staff	Staff changes or areas of low morale

Interactive question 4: Inherent risks from financial reporting policies

Fonesforall is a mobile phone network provider with its own retail outlets. It is currently offering the following package for £30 per month.

- ZX4 mobile phone handset
- 12-month subscription to the network
- 300 'free' call minutes per month (for 12 months)
- 500 'free' texts per month (for 12 months)
- Any unused call minutes or texts may be carried forward to the following month

The fair value of this package is estimated to be £500.

Requirement

Identify the risks associated with the treatment of revenue in relation to this package in the financial statements of Fonesforall.

See **Answer** at the end of this chapter.

6.1.3 Control risk

Control risk is the risk that client controls fail to detect material misstatements. A **preliminary assessment** of **control risk** at the planning stage of the audit is required to determine the level of controls and substantive testing to be carried out.

ISA 315 (Revised) Appendix 3 lists the matters that the auditor should consider when assessing an entity's system of internal control:

- Control environment
- The entity's risk assessment process
- The entity's process for monitoring the system of internal control
- The information system and communication
- Control activities
- Limitations in internal control

In this respect, a key initial audit question is "how does management control the business?". An understanding of this issue is a key element in an initial assessment of control risk.

Substantive and reliance strategies

For an ongoing client, the auditor will already have significant information on file regarding the control systems at the audit client. The audit strategy will therefore focus on **updating** this control information.

For a new client, a judgement on audit strategy will normally be deferred until after a more detailed understanding of the system of internal control is obtained. For the new client, the

auditor will **obtain information on the control systems** and then perform an **initial testing** of those controls to determine whether or not they are working correctly. Where these risk assessment procedures indicate that controls are not working correctly, then it is unlikely that the auditor will place reliance on those controls, as control risk will be set to maximum. **Substantive procedures** will be used instead.
However, if the risk assessment procedures indicate that controls are working correctly, then **some reliance** will be placed on internal controls. Control risk may be set only as either 'high' or 'low' in an all or nothing approach, as previously noted. Alternatively, there may be a possibility of setting control risk to an intermediate amount(s) within some firms' audit methodologies.

So, providing an initial determination of the nature, timing and extent of audit procedures, two possible audit strategies are normally identified:

- Substantive strategy – focusing on substantive testing (ie, tests of details and analytical procedures)
- Reliance strategy – focusing on tests of controls and reliance from inherent assurance

Notes

1 There will not be one strategy for the entire audit. Each business process or specific audit assertion will be allocated its own strategy. Similarly, each audit assertion may be allocated a different 'mix' of reliance and substantive strategy.

2 Auditing standards do require some substantive testing for each material class of transactions, account balances and disclosure, so the audit strategy for any one assertion will never be completely a reliance strategy.

3 However, it is possible (but unusual) that substantive testing may comprise entirely of analytical procedures, without any tests of details being carried out.

An auditor is more likely to follow a **reliance strategy** where:

- an entity uses **electronic data interchange** to initiate orders; there will be no paper documentation to verify;
- an entity provides **electronic services** to its customers eg, an internet service provider or telephone company. No physical goods are produced, with all information being collected and billing carried out electronically; and
- the test is for **understatement**.

An auditor is more likely to follow a **substantive strategy** where:

- there are **no controls** available for a specific audit assertion;
- the controls are assessed as **ineffective**;
- it is **inefficient** to test the effectiveness of the controls; and
- the test is for **overstatement**.

Whichever strategy is chosen, the auditor will **document** the reasons for choosing that strategy and then perform detailed auditing procedures in accordance with that strategy.

Control environment

Within an entity, the control system works within the **control environment**. A poor control environment implies that the control system itself will also be poor, because the entity does not place sufficient emphasis on having a good control environment.

So, the control environment sets the **philosophy of an entity** effectively influencing the 'control consciousness' of directors and employees. The importance of the enforcement of integrity and ethical values was illustrated in July 2011, with the closure of the *News of the World* newspaper resulting from phone hacking allegations.

Factors affecting the control environment include:

Factor	Explanation
Communication and enforcement of integrity and ethical values	An organisation should try to maintain the **integrity and ethical standing of the employees**. Membership of a professional body helps enforce ethical standards for professional staff. Ethics in other areas are maintained by ensuring rules do not encourage unethical conduct (eg, unrealistically high sales targets to earn commissions).
Commitment to competence	Each job should have a job description showing the standards expected in that job. Employees should then be hired with the **competences** to carry out the job without compromising on the quality of work produced.
Participation by those charged with governance	Those charged with governance should take an **active role** in ensuring ethical standards are maintained. For example, the audit committee should ensure that directors carry out their duties correctly in the context of the audit. Similarly, those charged with governance must ensure appropriate independence from the company they are governing.
Management philosophy	Management should **set the example** of following ethical and quality standards. Where management establish a risk management system and regularly discuss the effect of risks on an organisation then the auditor will gain confidence that the overall control environment is effective.
Structure of the organisation	The structure of the organisation should ensure that **authority is delegated appropriately** so that lower management levels can implement appropriate risk management procedures. However, responsibility for risk management overall is maintained by the board.
Reporting hierarchy	Within the organisation's hierarchy, each level of management has responsibilities for risk included in their job description. There should also be a **clear reporting system** so that objectives for risk management are communicated down the hierarchy, while identified risks are communicated back up the hierarchy for action.
HR policies and procedures	HR policies should have **appropriate policies** for ensuring the integrity of staff, both for new and existing employees. This should extend to include recruitment, retention, performance management and disciplinary procedures.

From a review of these factors, the auditor will form an opinion on the effectiveness of the control environment. The auditor will also consider the means by which the entity monitors controls eg, by the internal audit department. This in turn affects the opinion on how well the internal control systems will be implemented and operated.

Control risk will also increase where specific events occur within an organisation. Events that tend to increase control risk include the following:

- Use of new technology
- New or substantially amended information systems
- Hiring of new personnel, especially into key management roles
- Changes to the regulatory or operating environment

- Significant growth in the organisation
- Restructuring of the company or group
- Expansion of overseas operations

Control activities

Having assessed the control environment, the auditor will then identify and assess the operating effectiveness of control activities carried out by management. Control activities in this context are the **policies and procedures that help ensure management's directives are carried out**.

The auditor is required to differentiate between the following:

- Direct controls – these are considered precise enough to address risks of material misstatement at the assertion level
- Indirect controls – these are considered to be less precise and support direct controls

Control activities that the auditor will investigate include:

Control activity	Explanation
Physical or logical controls	Controls to ensure the security of assets including data files and computer programs (eg, not simply tangible assets such as company motor vehicles).
Authorisation and approval	Controls that confirm a transaction is valid and that the entity is satisfied should occur (such as the approval of an expenses claim).
Segregation of duties	Segregation of the authorisation of transactions, recording of transactions and custody of any related assets. For example, employees receiving cash should not be responsible for recording that cash in the receivables ledger – teeming and lading could occur.
Reconciliations	Comparison of two or more items to confirm their completeness and accuracy.
Verification	This includes comparing actual performance against agreed standards and policies, involving follow up to establish reasons for any variances.
Information processing controls	These are controls to check the completeness, accuracy and authorisation of the processing of transactions. Two types of controls are generally recognised: • General IT controls – over the information processing environment as a whole, for example to ensure the security of data processing operations and maintenance of adequate backup facilities. • Application controls – over the processing of individual transactions, again ensuring the completeness and accuracy of recording.

Where the auditor is satisfied regarding the ability of the control environment to process transactions correctly and control activities to identify deficiencies in that processing, then control risk can be set to a low figure. Obviously, where the control environment is weak, and control activities are missing, then control risk will be set to a higher level.

Control activities for transaction assertions

Within each class of transactions, the auditor will ensure that specific audit assertions have been achieved. Remember that for each assertion, a different 'mix' of control and substantive procedures may be used.

For each of the audit assertions relevant to transaction testing, specific control activities are normally available.

The assertions and control activities are summarised below.

Assertion	Explanation	Typical control activities
Occurrence	Transactions and events that have been recorded have occurred and pertain to the entity	• Segregation of duties • Daily/monthly reconciliation of subsidiary records with an independent review • Prenumbering of documents (with completeness of numbering confirmed
Completeness	All transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included	• Segregation of duties • Prenumbering of documents (with completeness of numbering confirmed) • Daily/monthly reconciliation of subsidiary records with an independent review
Accuracy	Amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described	• Internal confirmation of amounts and calculations • Monthly reconciliation of subsidiary records by an independent person
Cut-off	Transactions and events have been recorded in the correct accounting period	• Procedures for the prompt recording of transactions • Internal verification of cut-off at year end
Classification	Transactions and events have been recorded in the proper accounts	• Agreeing transactions against chart of accounts • Internal verification of the accuracy of posting

Monitoring the system of internal control

The auditor should also assess the means by which management monitors internal control over financial reporting and what (if any) action is taken to remediate any deficiencies identified. In many entities internal auditors fulfil this function. The impact on the audit of the existence of an internal audit function is dealt with in ISA 610 , Using the Work of Internal Auditors.

ISA 315 discusses the importance of such monitoring being undertaken on a timely basis by the entity and differentiates between manual and automated controls. The standard also requires auditors to understand whether monitoring is a separate activity or is simply built into the system of internal controls – the former should go further and be set up to establish whether there are any underlying reasons for control breaches.

6.1.4 Limitations in internal controls

Detection risk is the risk that audit procedures will fail to detect material errors. Detection risk relates to the inability of the auditors to examine all evidence. Audit evidence is usually persuasive rather than conclusive so some detection risk is usually present, allowing the auditors to seek 'reasonable confidence'.

The auditor's **inherent and control risk assessments** influence the **nature, timing and extent of substantive procedures** required to reduce detection risk and thereby audit risk.

However, despite the auditor's best efforts, there will always be some inherent limitations in any system of internal controls:

- Poor judgement by humans when making decisions and other forms of human error (such as fatigue)
- Poor design or operation of internal controls (such as a failure to act on an exception report)
- Poor ethics displayed by employees who decide to collude in order to circumvent certain controls

6.1.5 The entity's risk assessment process and information and communication

Both of these categories have coverage elsewhere in the learning materials, but in the context of how the auditor assesses the way they support the entity's system of internal controls there are points that will help at this stage:

- The auditor needs to understand how the entity **identifies and analyses risks** that could compromise its ability to achieve its objectives (in essence, business risks) which are relevant to the preparation of the financial statements in accordance with the applicable financial reporting framework (such as new information systems, changes in the entity's structure or rapid growth).
- The auditor also needs to understand how the entity's **information systems** contribute to the preparation of the financial statements, especially in the context of how transactions are processed, how the system addresses any overrides or bypasses to controls and how responsibilities for the preparation of the financial statements are **communicated** to relevant staff.

Data analytics tools may be used in risk assessment. Data analytics is discussed later in this chapter.

Professional skills focus: Structuring problems and solutions

Although you are unlikely to explicitly use the headings of inherent, control and detection risk when determining audit risk in a question, breaking it down into constituent parts can help you to assess risk more effectively.

Interactive question 5: Audit risk

Forsythia is a small limited company offering garden landscaping services. It is partly owned by three business associates, Mr Rose, Mr White and Mr Grass, who each hold 10% of the shares. The major shareholder is the parent company, Poppy Ltd. This company owns shares in 20 different companies, which operate in a variety of industries. One of them is a garden centre, and Forsythia regularly trades with it. Poppy Ltd is in turn wholly owned by a parent, White Holdings Ltd.

The management structure at Forsythia is simple. Of the three non-corporate shareholders, only Mr Rose has any involvement in management. He runs the day to day operations of the company (marketing, sales, purchasing etc) although the company employs two landscape gardeners to actually carry out projects. The accounts department employs a purchase clerk and a sales clerk, who deal with all aspects of their function. The sales clerk is Mr Rose's daughter, Justine. Mr Rose authorises and produces the payroll. The company ledgers are kept on Mr Rose's personal computer. Two weeks after the year end, the sales ledger records were severely damaged by a virus. Justine has a single printout of the balances as at the year end, which shows the total owed by each customer.

Forsythia owns the equipment which the gardeners use and pays them a salary and a bonus based on performance. Mr Rose is remunerated entirely on a commission basis relating to sales and, as a shareholder, he receives dividends annually, which are substantial.

Forsythia does not carry any inventories. When materials are required for a project, they are purchased on behalf of the client and charged directly to them. Most customers pay within the 60- day credit period, or take up the extended credit period which Forsythia offers. However, there are a number of accounts that appear to have been outstanding for a significant period.

Justine and her father do not appear to have a very good working relationship. She does not live at home and her salary is not significant. However, she appears to have recently purchased a sports car, which is not a company car.

The audit partner has recently accepted the audit of Forsythia as a new client. You have been assigned the task of planning the first audit.

Requirement

Identify and explain the audit risks arising from the above scenario.

See **Answer** at the end of this chapter.

7 Creative accounting

Section overview

- There is a spectrum of activity with respect to accounting policy choice. Creative accounting attempts to change users' perceptions of the performance and position of a business.
- The occurrence of creative accounting depends on both incentives and opportunity.
- The consequences of creative accounting depend upon a range of factors that change over time but are specific to individual companies.
- Creative accounting can be overt (disclosed) or covert (not disclosed).
- Red flags exist which may indicate that creative accounting practices have taken place.
- Empirical evidence supports the notion that creative accounting occurs on a widespread basis.

7.1 Introduction

One of the factors affecting the overall level of **financial statement risk** is the potential for creative accounting.

Directors have choices and they may exercise those choices to recognise values that do not reflect economic reality. A prime example is the choice of the cost model when an asset's fair value is significantly higher than cost. (**Note:** If an asset's fair value and value in use were lower than cost, then an impairment would be required under IAS 36 and directors would not have the discretion to disclose at cost.) Directors are more likely to make use of their discretion to mislead financial statement users if they have the **opportunity** (eg, imprecise accounting regulations, weak auditors) and **incentives** (eg, approaching the breach of a debt covenant, an impending takeover, profit-based bonus) to do so.

Creative accounting is covered from a financial reporting perspective in Chapter 24.

7.2 The nature of creative accounting

Definition

Creative accounting: The active manipulation of accounting results for the purpose of creating an altered impression of the underlying financial position or performance of an enterprise by using accounting rules and guidance in a spirit other than that which was intended when the rules were written.

This well-documented practice is a potential problem for auditors in assessing the underlying performance and position of a company and recent evidence suggests that it is one of the major issues facing financial reporting.

Accounting measures involve a degree of subjectivity, choice and judgement and it would be wrong to describe all such activity as creative accounting. Moreover, **creative accounting normally falls within permitted regulation** and is not therefore illegal. It is therefore often a question of fine judgement as to when creative accounting is of such an extent that it becomes misleading.

The spectrum of creative accounting practices may include the following (commencing with the most legitimate):

- Exercise of **normal accounting policy choice** within the rules permitted by regulation (eg, first in, first out and average cost for inventory valuation)
- Exercise of a degree of estimation, judgement or prediction by a company **within reasonable bounds** (eg, non-current asset lives)
- Judgement concerning the **nature or classification of a cost** (eg, expensing and capitalising costs)
- Systematic selection of **legitimate policy choices and estimations** to alter the perception of the position or performance of the business in a uniform direction
- Systematic selection of **policy choice and estimations** that fall on the margin of permitted regulation (or are not subject to regulation) in order to alter materially the perception of the performance or position of the business
- Setting up of **artificial transactions** to create circumstances where material accounting misrepresentation can take place
- **Fraudulent activities**

It can thus be a matter of fine judgement for an auditor as to where within this spectrum creative accounting becomes unacceptable.

Companies may also seek to manipulate the perception of their performance and position by altering underlying transactions, rather than just the way they are recorded. Accounting regulation seeks to limit the effects of this behaviour in a number of ways as previously discussed. Nevertheless, while it may seek to report faithfully transactions that actually take place, it cannot regulate for transactions which do not take place, or which are delayed in order to manipulate the perception of performance or position. These might include:

- deferring discretionary expenditure (eg, maintenance costs, R&D);
- changing the timing of the sale of investments or other assets; or
- delaying investment or financing decisions.

Context example: Patisserie Valerie

UK café chain Patisserie Valerie hit the headlines in October 2018 when trading in its shares was suspended following allegations of irregularity about its financial position. Soon after, the company's finance director was also suspended as the size of the hole in its finances began to grow. In November 2018, the FRC announced that it was launching an investigation into the audit of the holding company, Patisserie Holdings. By January 2019, the company had been placed into administration and was later sold for £5 million to private equity investors. In June 2019, five people were arrested by the UK Serious Fraud Office in connection with the deficit, which at that time was estimated to be £94 million.

The events of Patisserie Valerie came hot on the heels of the Carillion controversy of 2017, which have both been cited as the final straw for the existing UK regulatory regime for corporate reporting and auditing. The lessons here seem obvious: poor quality audit and inadequate responses to fraud have serious economic consequences and therefore need to be taken more seriously.

(Sources: Economia and BBC News Website, 2018 and 2019)

Professional skills focus: Applying judgement

Scenarios in the exam are very likely to require you to be on the lookout for possible areas of creative accounting. Don't forget the importance of maintaining professional scepticism and displaying critical thinking at all times when reading the contents of a question.

7.3 Causes of creative accounting – opportunity

The causes of creative accounting have two key elements:

(a) Opportunity

(b) Incentives

Where these two elements both exist then the **risks of creative accounting taking place are greatest**. This section looks at opportunity. The following section looks at incentives.

It is important for the auditor to be aware of the causes of creative accounting in order to highlight the circumstances, where there is the greatest risk or incentives for creative accounting to take place.

The causes of **opportunity** for creative accounting include the following:

- **Subjectivity** – Areas of subjectivity lend themselves to a greater degree of choice, judgement and uncertainty.
- **Complexity** – Complex industries and transactions are difficult to regulate precisely and give more scope for manipulation.
- **Inadequate corporate governance** – Inadequate or inappropriate controls over directors may permit greater discretion.
- **Insufficiently independent auditors** – Auditors may come under increased managerial pressure to approve creative accounting practices.
- **Imprecise regulations** – Where regulations are imprecise or inadequate, companies have

greater scope to exercise discretion, and auditors have a poor benchmark to challenge the selected accounting procedures.

- **Inadequate sources of information** – Where reliable sources of audit evidence exist (eg, to challenge management estimations) the scope for effective manipulation is more limited.
- **Inadequate penalties** – Where creative accounting is discovered to have misled users, the penalties for the company, and for the directors, are regarded by some as inadequate to provide sufficient disincentives.

7.4 Causes of creative accounting – incentives

The following have been put forward as incentives for companies/managers engaging in creative accounting:

- **Income smoothing** – Companies normally prefer to show a steady trend of growth in profits, rather than volatility with significant rises and falls. Income smoothing techniques (eg, declaring higher provisions and deferring income recognition in good years) contribute to reducing volatility in reported earnings.
- **Achieving forecasts** – Where forecasts of future profits have been made, reported earnings may be manipulated to tie in with these forecasts.
- **Profit enhancement** – This is where current year earnings are boosted to enhance the short-term perception of performance.
- **Maintain or boost share price** – Where markets can be made to believe that increased earnings represent improved underlying commercial performance, then share price may rise, or at least be higher than it would be in the absence of creative accounting.
- **Accounting-based contracts** – Where accounting-based contracts exist (eg, loan covenants, profit- related pay) then any accounting policy that falls within the terms of the contract may significantly impact on the consequences of that contract. For example, the breach of a gearing-based debt covenant may be avoided by the use of off balance sheet financing.
- **Incentives for directors** – There may be personal incentives for directors to enhance profit in order to enhance their remuneration. Examples might include: bonuses based on earnings per share (EPS), or share incentive schemes and share option schemes that require a given EPS before they become operative. Directors may also benefit more indirectly from creative accounting by increasing the security of their position.
- **Taxation** – Where accounting practices coincide with taxation regulations there may be an incentive to reduce profit in order to reduce taxation. In these circumstances, however, it may be necessary to convince not only the auditor but also HMRC.
- **Regulated industries** – Where an industry is currently, or potentially, regulated then there may be an incentive to engage in creative accounting to reduce profit in order to influence the decisions of the regulator. This may include utilities where regulators may curtail prices if it is perceived that excessive profits are being earned. It may also be relevant to avoid a reference to the Competition Commission.
- **Internal accounting** – A company as a whole may have reason to move profits from division to division (or subsidiary to subsidiary) in order to affect tax calculations or justify the closure/expansion of a particular department.
- **Losses** – Companies making losses may be under greater pressure to enhance reported performance.
- **Commercial pressures** – Where companies have particular commercial pressures to enhance the perception of the company there is increased risk of creative accounting; for example, a takeover bid, or the raising of new finance.

Thus, a range of stakeholders may have incentives to engage in creative accounting. In particular, however, an appropriate degree of professional scepticism should be applied where benefits arise for directors, as they are also the group responsible for implementing creative accounting practices.

7.5 The consequences of creative accounting

It is important for the auditor to understand the consequences of creative accounting, as:

- It enables an **understanding of the motivations and reasons** for the company's directors to engage in the practice. (For instance, the existence and nature of a debt covenant that may be affected by creative accounting.)
- It **enhances the understanding of whether the practice is material** ie, whether it would reasonably influence decisions made.
- It enables an **understanding of the continued impact of a particular creative accounting practice in future years' financial statements** and whether the impact will be sustainable year on year.

The consequences of creative accounting depend crucially upon whether or not it is disclosed.

Overt creative accounting refers to practices, which may change reported profits or the statement of financial position, but that are **disclosed externally** to financial statement users. Examples may include:

- not depreciating non-current assets
- capitalising development costs
- significant provisioning
- changing depreciation policy

Covert creative accounting refers to practices that are used to enhance profitability or asset values but are **not disclosed**. Examples might be:

- the timing of revenue recognition on complex long-term transactions
- the treatment of overhead allocations
- many decisions to capitalise or expense cash outlays

As a result, such covert practices are not readily identifiable by outside users, who are thus unable, in some cases, to distinguish increases in reported earnings arising as a result of accounting manipulation, from those arising from improvements in substantive underlying transactions. The potential consequences of covert creative accounting (eg, for share price movements) are therefore likely to be more substantial than for overt creative accounting.

7.6 Sustainability

Some creative accounting practices are sustainable in the long term while others may only serve to enhance the current year's profit, but only with the effect that future profits are correspondingly reduced.

Sustainable practices may include the following:

- **Income smoothing** – assuming it is smoothed at a normal level of profitability, it may be sustained indefinitely
- **Off balance sheet financing**

Unsustainable practices include the following:

- **Capitalisation of expenses** – if, for instance, annual development costs are inappropriately capitalised and amortised over 10 years then, after that period, assuming constant expenditure, the profit will be equivalent for either write-off or amortisation policies (though not the statement of financial position) as there will be 10 amounts of 10% amortisation recognised in profit or loss

- **Revenue recognition** – bringing forward the recognition of revenues may initially enhance profit, but at the cost of reducing future profits

7.7 Some specific consequences

Share price effects

Where creative accounting practices are disclosed then one would expect that, in a semi strong efficient market, investors would see through the manipulation and correctly price shares, with creative accounting having little effect. However:

- the market may not always be efficient;
- accounting-based contracts may be affected; and
- complex series of transactions may mean that markets fail to appreciate fully the impact of creative accounting.

Covert creative accounting is likely to include all the above effects but in addition, even where the market is semi-strong efficient, it cannot always 'see through' the creative accounting and shares could be mispriced. This may result in shareholders suffering an undue loss.

Recent revelations regarding creative accounting have resulted in significant falls in the share prices of the companies concerned providing evidence of previous mispricing. However, shares prices also fell in other companies, as markets generally placed less trust in reported earnings and auditors were perceived as being unable to prevent creative accounting.

Accounting-based contracts

Whether creative accounting is covert or overt, it can affect the application of accounting-based contracts, so long as the selected accounting treatment falls within the terms of that contract.

Typically, a restrictive covenant on gearing, or interest cover, may be avoided by enhancing equity or earnings. This may benefit one stakeholder (eg, shareholders) but disadvantage another (eg, debtholders).

7.8 Red flags and detection

The best detection techniques for creative accounting are a good knowledge of financial reporting regulations and a good understanding of the business. There may, however, be more general techniques and indicators that can suggest that a company is engaging in creative accounting practice. These include the following:

- **Cash flows** – Operating cash flows are systematically out of line with reported operating profits over time.
- **Reported income and taxable income** – Is financial reporting income significantly out of line with taxable income with inadequate explanation or disclosure?
- **Acquisitions** – Where a significant number of acquisitions have taken place, there is increased scope for many creative accounting practices.
- **Financial statement trends** – Indicators include: unusual trends, comparing revenue and EPS growth, atypical year-end transactions, flipping between conservatism and aggressive accounting from year to year, level of provisions compared to profit indicating smoothing, EPS trend, timing of recognition of exceptional items.
- **Ratios** – Ageing analyses revealing old inventories or receivables, declining gross profit margins but increased net profit margins, inventories/receivables increasing more than sales, gearing changes.

- **Accounting policies** – Consider if there is the minimum disclosure required by regulation, changes in accounting policies, examine areas of judgement and discretion. Consider risk areas of off balance sheet refinancing, revenue recognition, capitalisation of expenses, significant accounting estimates.
- **Changes of accounting policies and estimates** – Is the nature, effect and purpose of these changes adequately explained and disclosed?
- **Management** – Estimations proved unreliable in the past, minimal explanations provided.
- **Actual and estimated results** – Culture of always satisfying external earnings forecasts, absence of profit warnings, inadequate or late profit warnings leading to 'surprises', interim financial statements out of line with year-end financial statements.
- **Incentives** – Management rewarded on reported earnings, profit-orientated culture exists, other reporting pressures eg, a takeover.
- **Audit qualifications** – Are they unexpected and are any auditors' adjustments specified in the audit report significant?
- **Related party transactions** – Are these material and how far are the directors affected?

The above is not a comprehensive list, but merely includes some main factors. Also, it is not suggested that the above practices necessarily mean there is creative accounting but, where a number of these factors exist simultaneously, then the auditor should be put 'on inquiry' to make further investigations.

7.9 Examples of creative accounting techniques

A number of examples of creative accounting have been given above and throughout these learning materials in the context of their application. The following list draws some of these together and provides further examples under key headings. The list is not meant to be comprehensive.

7.9.1 Timing of operating expenses

- Underprovisioning in poor years
- Overprovisioning in good years
- Manipulation of reserves
- Aggressive capitalisation of costs
- Optimistic asset lives
- Accelerating expenses in good years
- Increased write-downs and write-offs in good years
- Exceptional gains timed to offset exceptional losses

7.9.2 Revenue recognition

- Premature recognition of revenues
- Recording out of period revenue
- Recognition of revenue of service contracts before the service being performed
- Recognition of sales before physical movement of goods
- Front-end recognition of sales that should be spread over more than one accounting period
- Percentage of completion estimates in construction industry
- Cut-off misapplied

7.9.3 Off balance sheet financing

In some circumstances transactions may be structured in order to allow a particular accounting treatment (eg, making a finance lease appear to be an operating lease) rather than presenting the fairest view. This is one of the primary reasons for the large quantity of disclosure standards (as against measurement standards) in previous years.

8 Materiality

CHAPTER 5

Section overview

- Materiality considerations are important at the planning stage.
- An item might be material due to its nature, value or impact on readers of financial statements.

8.1 Revision of materiality

ISA 320, *Materiality in Planning and Performing an Audit* states that the auditor's frame of reference for materiality should be based on the relevant financial reporting framework. IAS 1 gives the following definition:

Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements.

Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or combination of both, could be the determining factor.

Materiality criteria

An item might be material due to its:

Nature	Given the definition of materiality that an item would affect the readers of the financial statements, some **items** might **by their nature affect readers**. Examples include **transactions related to directors**, such as remuneration and contracts with the company.
Value	Some items will be significant in the financial statements by virtue of their **size**; for example, if the company had bought a piece of land with a value which comprised three-quarters of the asset value of the company, that would be material. That is why materiality is often expressed in terms of **percentages** (of assets, of profits).
Impact	Some **items may by chance have a significant impact** on financial statements; eg, a proposed journal which is not material in size could convert a profit into a loss. The difference between a small profit and a small loss could be material to some readers.

Although there are general guidelines on how materiality might be calculated in practice, the calculation involves the application of judgement. It should be reassessed throughout the course of the audit as more information becomes available. Note that as materiality has both quantitative and qualitative aspects risk assessment must include the analysis of both quantitative and qualitative data.

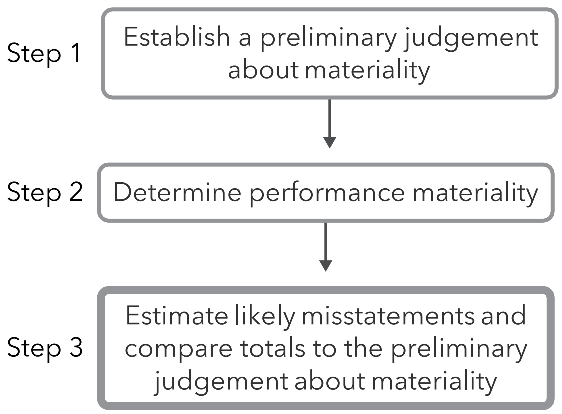
Users' needs

The auditor must consider the needs of the users of the financial statements when setting materiality. The ISA indicates that it is reasonable for the auditor to assume that users:

- Have a reasonable knowledge of the business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence
- Understand that financial statements are prepared and audited to levels of materiality
- Recognise the uncertainties inherent in the measurement of amounts based on the use of estimates, judgement and the consideration of future events
- Make reasonable economic decisions on the basis of the information in the financial statements

8.2 Applying materiality

The application of materiality to an audit can be summarised in three key steps: Figure 5.4: Steps in applying materiality on an audit



Steps 1 and 2 would normally be performed as part of the planning process. Step 3 is normally performed as part of the review stage of the audit when the auditor evaluates the audit evidence.

Auditors of companies applying the UK Corporate Governance Code are required to make significant disclosures in the auditor's report about how they have applied materiality in their audit. However till now no such requirement applies to the audits in Bangladesh.

8.2.1 Preliminary judgement

Materiality considerations during **audit planning** are extremely important. The assessment of materiality at this stage should be based on the most recent and reliable financial information and will help to determine an effective and efficient audit approach. Materiality assessment will help the auditors to:

- determine the amount of audit work necessary to facilitate audit efficiency and effectiveness;
- put audit risk in context;
- decide whether to use sampling techniques;
- determine the applicability of accounting standards which normally apply only to material items;
- evaluate uncorrected misstatements during the audit; and
- evaluate what level of error is likely to lead to a modified audit opinion.

In specifying materiality, an auditor should establish a benchmark (or benchmarks) to which a percentage factor is applied. Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements
- Items on which the attention of the users tends to be focused
- The nature of the entity, where it is in its life cycle and the industry and economic environment in which it operates
- The entity's ownership structure and the way it is financed
- The relative volatility of the benchmark

The following materiality benchmarks are typically used:

Benchmark	Threshold
Profit before tax	Approx. 5%
Adjusted profit before tax	Approx. 5%
Total revenue	Approx. 1%
Total assets	Approx. 1–2%
Equity	Approx. 1–2%

(The benchmarks suggested above are based on information from the UK FRC publication *Extended Auditor's Reports: A review of Experience in the First Year*, 2015.)

The following points should be noted:

- There is some variation used in the methods to determine materiality within and between audit firms.
- Multiple measures are sometimes used to determine materiality.
- Adjusted profit before tax and profit before tax are the most commonly used measures.

Determining the level of materiality is a matter of professional judgement, rather than applying benchmarks mechanically. In applying such judgements, the auditor should consider any relevant qualitative factors, including:

- whether it is a first-year engagement;
- deficiencies in controls;
- material misstatements in prior years;
- risk of fraud;
- significant management turnover;
- unusually high market pressures;
- sensitivity of covenants in loan agreements to changes in the financial statements; and
- effect of changes in results on earnings trends.

By far the most common level of materiality for listed company auditors is 5% of adjusted profit before tax. It is also necessary to determine a materiality threshold for reporting any unadjusted differences to the audit committee. This will be much lower than overall materiality..

In the case of a group audit, the group auditor will also set materiality for the group as a whole, as well as component materiality for any component auditors. Component materiality is always less than group materiality.

8.2.2 Performance materiality

The preliminary assessment of materiality, as referred to above, is in the context of the financial statements as a whole. However, if the audit procedures are planned solely to detect individually material misstatements this would:

- overlook the fact that the aggregate of individually immaterial misstatements could cause the financial statements to be materially misstated; and
- leave no margin for possible undetected misstatements.

Further materiality levels must therefore be set before audit procedures are designed and performed. The requirement to do so was introduced into ISA 320 as part of the IAASB's Clarity Project, and these lower materiality levels are referred to as **performance materiality**. Seen as a 'working level of materiality', performance materiality is a concept that most experienced auditors would have applied throughout their careers.

The auditor must set an amount or amounts at less than the materiality for the financial statements as a whole and this is known as **performance materiality**. This could be set in two ways:

(a) as a judgemental estimate to reduce the probability that the aggregate of uncorrected and undetected misstatements exceeds the materiality for the financial statement as a whole; or

(b) specific materiality levels may be set for particular classes of transactions, account balances or disclosures that could have a particular influence on users' decisions in the particular circumstances of the entity.

Different levels of materiality may therefore be used in the various audit procedures carried out. The following example illustrates, in a simplistic way, the role of performance materiality in an audit.

Context example: Performance materiality

The auditor of Company A has set materiality for the financial statements as a whole at

£100,000 During the audit, the following misstatements were identified:

(a) Misclassification of abortive research and development expenses as an intangible asset of £41,000. This is the only intangible asset on the statement of financial position.

(b) Overstatement of non-current assets by £50,000 due to cut-off errors.

(c) Overstatement of receivables by £29,000 representing the unpaid balance from a customer which has been liquidated during the period.

Considering each of the misstatements on an individual basis, the auditor may overlook the misstatements above. This would give rise to an aggregate of uncorrected misstatements of £120,000 – exceeding materiality for the financial statements as a whole.

In addition, the uncorrected misstatement (1) could have misled the users of the financial statements, whose attention would have been drawn to the company's new, and only, intangible assets.

The auditor would avoid the risk of giving an inappropriate audit opinion by applying performance materiality:

(a) **Set a general performance materiality at £50,000 to reduce the probability that the aggregate of uncorrected misstatements would exceed materiality for the financial statements as a whole:** This would identify misstatement (2) as requiring adjustment.

(b) **Set performance materiality specific to intangible assets at £40,000 to reflect the specific risks associated with this account:** This would identify misstatement (1) as requiring adjustment.

(c) Now, provided management agrees to correct misstatements (1) and (2), the only adjustment which remains uncorrected is misstatement (3). At £29,000, this is now less than 30% of materiality for the financial statements as a whole

Performance materiality should be used in both the planning and fieldwork stages of the audit. In the November 2011 issue of the *ICAEW Audit & Assurance Faculty newsletter*, the article 'Living in a material world' by David Gallagher usefully sets out four circumstances in which performance materiality can be applied:

At the planning stage:

(1) to determine when no work is necessary, and where evidence is required, the extent of that evidence; and

(2) to help identify which items to test (for example, if a substantive test of detail approach is adopted, the auditor may consider selecting all items above performance materiality first, and then consider whether any, and if so how many, further items should be sampled).

At the fieldwork stage:

(3) to help evaluate the results of sample tests (for example, if on a particular test the extrapolated difference of potential misstatements is less than materiality, the auditor may conclude that sufficient audit evidence had been obtained in this area); and

(4) to help evaluate the results of analytical procedures (for example, if the results of a reasonableness test produced a difference between the predicted and actual amounts which is less than performance materiality, the auditor may conclude that sufficient audit evidence had been obtained in this area).

Students who work in an audit practice may have come across **tolerable misstatement** (previously called 'tolerable error') In carrying out audit engagements. Essentially, tolerable misstatement is an example of how the concept of performance materiality is applied to **sampling** (points (2) and (3) above).

What constitutes sufficient audit evidence, and the different audit procedures, are covered in further detail in Chapter 6. However, you should already be familiar with these topics from your earlier studies.

8.2.3 Estimation of likely misstatements

Towards the end of the audit, the auditor will aggregate the misstatements from each account balance, class of transaction or disclosure (including both known and likely misstatements) and compare this with the preliminary assessment of materiality. Where additional information has come to light the preliminary assessment of materiality **may need to be revised**. If this is the case, the circumstances should be adequately documented. Comparison of the aggregated misstatements and materiality will determine whether the financial statements require adjustment.

Like materiality for the financial statements as a whole, performance materiality is linked to audit risk. Where the audit risk has been revised during an audit, and the materiality level for the financial statements as a whole has been reduced, the auditor must consider whether performance materiality also needs to be revised. This may affect the nature, timing and extent of further audit procedures.

8.2.4 Auditor's report – Example from UK market

Auditors of companies applying the UK Corporate Governance Code must disclose the materiality level used in the audit for the financial statements as a whole. This area is covered in more detail in Chapter 8 of this Workbook, but for now it may be helpful to see a real-life example of such a disclosure. For instance, PwC's auditor's report for Barclays plc (in relation to the 2016 Annual Report) included the following statement.

"Overall group materiality [was set at]: £320 million [which represents] 5% of Barclays Core profit before tax excluding notable items. The use [of this measure of profit] is appropriate as it reflects the underlying business management is focusing upon and will be what is left once disposals from Non- core have occurred."

(Source: Barclays plc (2016) *Building the bank of the future: Annual Report*. [Online]. Available from: https://home.barclays/content/dam/home-barclays/documents/investor-relations/ResultAnnouncements/2016FYResults/Barclays%20PLC%20Annual%20Report%202016.pdf [Accessed 27 May 2022])

Deloitte's auditor's report for Tesco plc (in relation to the 2016 Annual Report) includes the following description of the basis on which materiality was derived, making reference to the effect on the materiality level of the change of auditors.

"We determined materiality for the Group to be £50 million (2014/15: materiality determined by the previous auditor of £50 million). Professional judgement was applied in determining an appropriate level of materiality and we considered a number of profit based and other measures with reference to the Group's performance. We concluded that it was appropriate to determine materiality with reference to the Group's average profitability over a three year period (2013/14, 2014/15, and 2015/16), adjusted for exceptional items.

In our professional judgement, we believe that the use of an adjusted profit measure is appropriate as the amounts which have been excluded from the Group's profit before tax are one-off items which would otherwise skew the level of materiality determined and are not reflective of the Group's trading activity. However, we capped the materiality determined to that applied by the previous auditor in the light of the Group's lower level of profit in the current year and as a result of 2015/2016 being our first year of appointment."

(Source: Tesco (2016) *Annual Report and Financial Statements*. [Online]. Available from: www.tescoplc.com/media/264194/annual-report-2016.pdf [Accessed 27 May 2022])

Ernst and Young's auditor's report for J Sainsbury plc (in relation to the 2016 Annual Report) provides information about both overall materiality and performance materiality as follows:

"We determined materiality for the Group to be £31.9 million, which is 5% of profit before tax excluding one-off items of £90 million as described in note 3. We believe that this materiality basis provides us with the best assessment of the requirements of the users of the financial statements. This is consistent with the approach taken by auditors in the prior period.

On the basis of our risk assessments, together with our assessment of the Group's overall control environment and this being our first period of engagement, our judgement was that performance materiality was approximately 50% of our planning materiality, namely £16 million."

(Source: J Sainsbury plc (2016) *Annual Report and Financial Statements.* [Online]. Available from: www.about.sainsburys.co.uk/~/media/Files/S/Sainsburys/documents/reports-and-presentations/annual-reports/annual-report-2016.pdf [Accessed 27 May 2022])

8.3 Problems with materiality

As discussed above, materiality is a matter of judgement for the auditor. Therefore, prescriptive rules will not always be helpful when assessing materiality. A **significant risk** of prescriptive rules is that a **significant matter**, which **falls outside the boundaries of the rules**, could be overlooked, leading to a **material misstatement in the financial statements**.

The percentage guidelines of assets and profits that are commonly used for materiality (eg, those referred to in section 8.2.1) must be handled with care. The auditor must bear in mind the **focus** of the company being audited.

In some companies, **post-tax profit** is the key figure in the financial statements, as the level of dividend is the most important factor in the accounts.

In **owner-managed businesses**, if owners are paid a salary and are indifferent to dividends, the key profit figure stands higher in the statement of profit or loss and other comprehensive income, say at **gross profit** level. Alternatively in this situation, the auditor should consider a figure that does not appear on the statement of profit or loss and other comprehensive income: **profit before directors' salaries and benefits**.

Some companies are **driven by assets** rather than the need for profits. In such examples, higher materiality might need to be applied to assets. In some companies, say charities, **costs** are the driving factor, and materiality might be considered in relation to these.

While rules or guidelines are helpful to auditors when assessing materiality, they must always keep in mind the **nature** of the business they are dealing with. Materiality must be **tailored to the business and the anticipated user** of financial statements, or it is not truly materiality. The extracts from auditors' reports included in section 8.2.4 above demonstrate how these principles are applied in practice.

The UK FRC published **Audit Quality Thematic Review: Materiality** in December 2017 and found that the quality and frequency of materiality judgements displayed by audit firms was improving: for example, in three out of the eight firms visited, the UK FRC found that performance materiality was reduced to reflect the increased risk presented by the first year of audit. The review did conclude that the disclosure of judgements associated with materiality

Professional skills focus: Applying judgement

could be explained further by auditors within the auditor's extended report and that there should be greater dialogue about materiality between audit committees and their external auditors to ensure full visibility of the audit approach, but overall, there was optimism that this area was seeing some improvement in quality.

The evaluation of materiality often starts with a calculation but encourages auditors to consider other factors as well when determining what should really be the focus in the audit. This approach of combining both quantitative and qualitative factors is therefore a good way of demonstrating judgement.

Interactive question 6: Materiality (1)

You are the manager responsible for the audit of Albreda Ltd. The draft consolidated financial statements for the year ended 30 September 20X6 show revenue of £42.2 million (20X5 £41.8 million), profit before taxation of £1.8 million (20X5 £2.2 million) and total assets of £30.7 million (20X5 £23.4 million). In September 20X6, the management board announced plans to cease offering 'home delivery' services from the end of the month. These sales amounted to £0.6 million for the year to 30 September 20X6 (20X5 £0.8 million). A provision of £0.2 million has been made at 30 September 20X6 for the compensation of redundant employees (mainly delivery van drivers).

Requirement

Comment upon the materiality of these two issues. See **Answer** at the end of this chapter.

Interactive question 7: Materiality (2)

You are the auditor of Oscar Ltd and are in the process of planning the audit for the year ended 31 December 20X8. In the past the audit of this company has been straightforward. The following information is available:

	20X8	20X7
	£'000	**£'000**
Total assets	1,800	1,750
Total revenue	2,010	1,900
Profit before tax	10	300

Materiality has been calculated by a colleague as follows: Profit before tax = £10,000 × 5% = £500

Requirement

Comment on the suitability of the planning materiality figure.

See **Answer** at the end of this chapter.

9 Responding to assessed risks

Section overview

Further audit procedures should be designed in response to the risks identified.

As a result of the auditor's risk assessment and assessment of materiality an **audit strategy** will be developed in response. ISA 330, *The Auditor's Responses to Assessed Risks* makes the following points in this context which you should be familiar with.

9.1 Overall responses

The auditor should design and implement **overall responses** to address the risks of material misstatement at the financial statement level. This may include the following:

- Emphasising to the audit team the need to maintain **professional scepticism** in gathering and evaluating audit evidence
- Assigning more **experienced staff**, those with **special skills** or using **experts**
- Providing **more supervision**
- Incorporating **additional elements of unpredictability** in the selection of further audit procedures

The auditor may also make general changes to the nature, timing or extent of audit procedures, for example by performing substantive procedures at the period end instead of at an interim date.

These decisions will take into account the auditor's assessment and understanding of the control environment.

9.2 Audit procedures responsive to risks of material misstatement at the assertion level

The auditor is required to design and perform procedures which will address the risks identified. The ISA emphasises the link between **further audit procedures and the risk assessment process**.

Factors which the auditor will consider include the following:

- The reasons for the risk assessment at the assertion level for each class of transaction, account balance or disclosure
- The likelihood of material misstatement due to the particular characteristics of the class of transaction, account balance or disclosure involved
- Whether the risk assessment takes account of relevant controls and so requires the auditor to obtain evidence to determine whether the controls are operating effectively

The auditor shall obtain more persuasive audit evidence the higher the assessment of risk.

The auditor will then determine the **nature, timing and extent of further audit procedures**. We will look at this aspect of the audit in detail in Chapter 6.

9.3 Evaluating the sufficiency and appropriateness of audit evidence obtained

Based on the audit procedures performed and the evidence obtained, the auditor should conclude whether sufficient, appropriate audit evidence has been obtained to reduce the risk of material misstatement to an acceptably low level. While this will be considered by the auditor throughout the audit, it is of particular relevance at the review stage of the audit. We will consider this in more detail in Chapter 6.

9.4 Documentation

The ISA emphasises the need to document the link between the audit procedures and the assessed risks. These matters should be recorded in accordance with ISA 230, *Audit Documentation*. You should be familiar with the principles of this ISA from your earlier studies.

Professional skills focus: Concluding, recommending and communicating

Whatever the auditor's response to the risk assessment carried out, it must follow on logically from the evidence collected at the planning stage or the audit may not address the correct audit risks.

10 Other audit methodologies

Section overview

Other audit methodologies include:

- systems audit;
- transaction cycle approach; and
- balance sheet audit approach.

10.1 Introduction

In this chapter we have looked in detail at business risk and audit risk. However, there are a number of other audit approaches which may be adopted.

10.2 Systems audit

An auditor may predominantly test controls and systems, but substantive testing can **never** be eliminated entirely. It is always used in conjunction with another approach.

You should be familiar with the systems and controls approach to auditing from your previous studies.

Management are required to implement a system of controls which is capable of fulfilling its duty of **safeguarding the assets** of the shareholders.

Auditors assess the system of controls put in place by the directors and ascertain whether they believe it is effective enough for them to be able to rely on it for the purposes of their audit.

If they believe that the system is effective, they carry out tests of controls to ensure that the control system operates as it is supposed to. If they believe that the control system is ineffective, they assess control risk as high and undertake higher levels of substantive testing.

The key control objectives and procedures over the main cycles of sales, purchases and wages were studied at length in your previous studies. If you do not feel confident in what they are, you should go back to your learning materials in these areas and revise them now.

An auditor may choose predominantly to carry out substantive tests on the transactions and balances of the business in the relevant period, but if internal control systems are particularly weak then no amount of substantive testing may give adequate assurance (eg, if point of sales controls over cash receipts are inadequate, then substantive testing may never detect material understatement of revenues).

Two approaches to substantive testing are:

- the **transaction cycle approach**; and
- the **balance sheet approach**.

10.3 Transaction cycle approach

Cycle testing is in some ways closely linked to systems testing, because it is based on the same systems.

When auditors take a cycle approach, they test the transactions which have occurred, resulting in the entries in the statement of profit or loss and other comprehensive income (for example, sales transactions, inventory purchases, asset purchases, wages payments, other expenses).

They would select a sample of transactions and test that each transaction was valid and complete and processed correctly throughout the cycle. In other words, they substantiate the transactions which appear in the financial statements.

The key business cycles are outlined below. Remember that you know what the processes should be in the cycle (you have assessed the system and controls previously). Under this approach, you are ensuring that individual transactions were processed correctly. Hence, the cycles outlined below should correspond to the controls processes you are already aware of.

Figure 5.5: Sales cycle

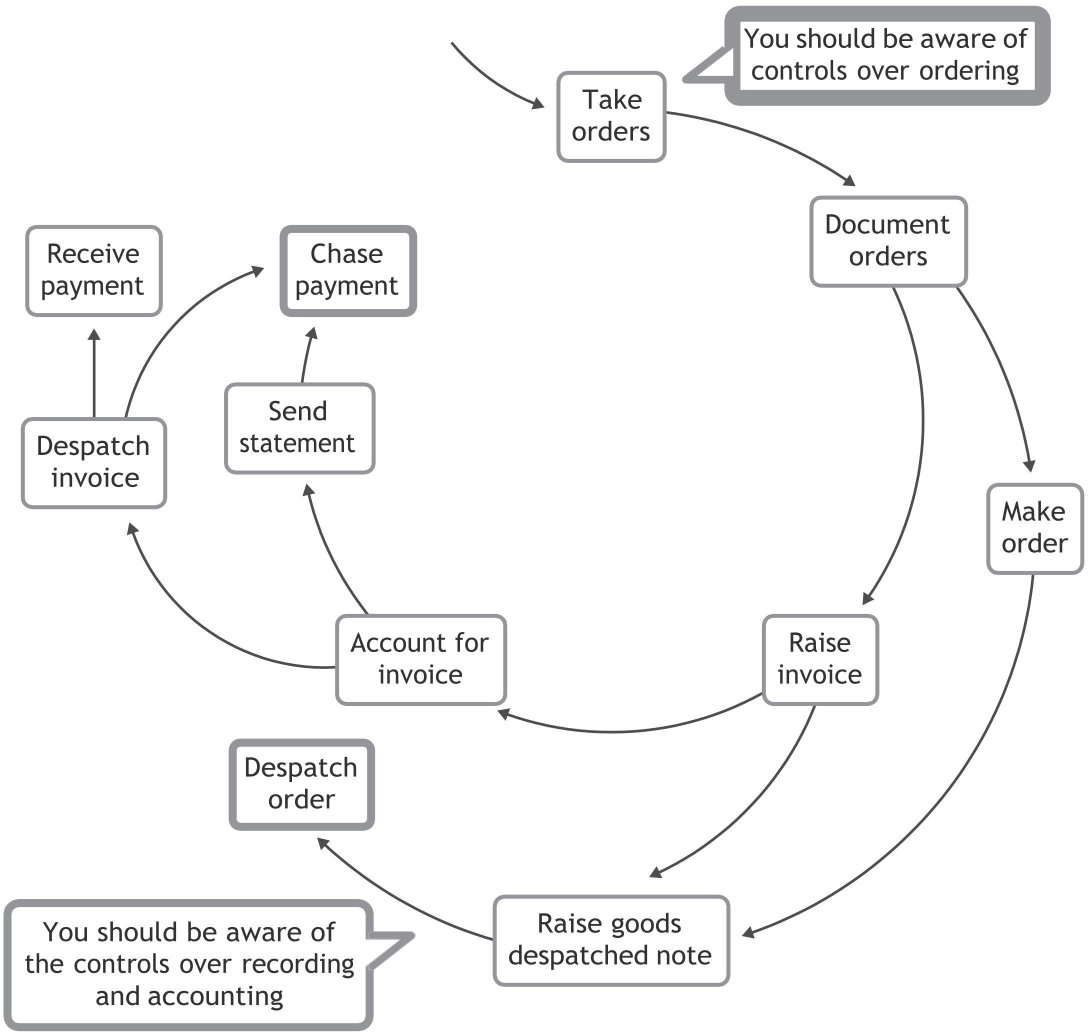
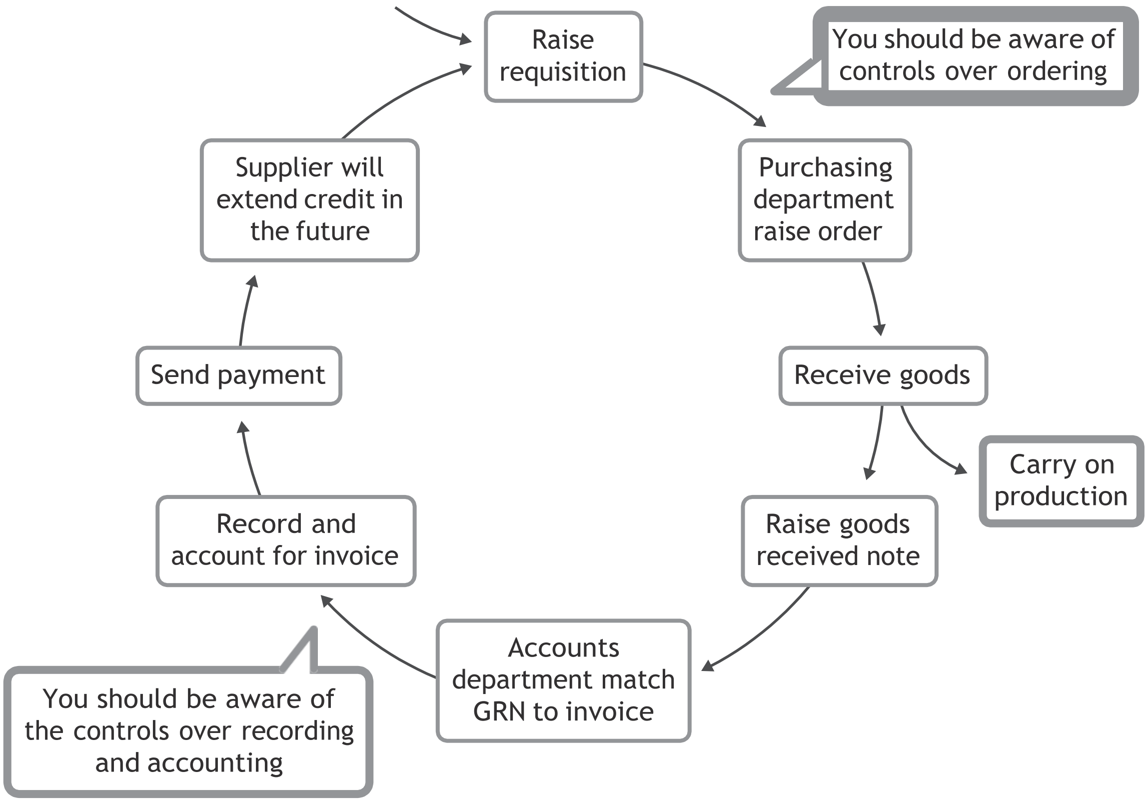


Figure 5.6: Purchases cycle



The auditor should be able to find an audit trail for each transaction, for example in the purchases cycle:

- Requisition
- Invoice
- Order
- Ledger and daybook entries
- GRN
- Payment in cashbook

10.4 Balance sheet approach

An alternative to the cycles (or transactions) approach to auditing is to take the balance sheet approach. This is the most common approach to the substantive part of the audit, after controls have been tested.

The statement of financial position (balance sheet) shows a snapshot of the financial position of the business at a point in time. It follows that if it is fairly stated and the previous snapshot was fairly stated then it is reasonable to undertake lower level testing on the transactions which connect the two snapshots; for example, analytical procedures.

Under this approach, therefore, the auditors seek to concentrate efforts on substantiating the closing position in the year, shown in the statement of financial position, having determined that the closing position from the previous year (also substantiated) has been correctly transferred to be the opening position in the current year.

You should be aware of the financial statement assertions and the substantive tests in relation to the major items on the statement of financial position from your previous studies. We will also review these in more detail in Chapter 6.

10.4.1 Relationship with business risk approach

The substantive element of an audit undertaken under a business risk approach is restricted due to the high use of analytical procedures. However, the element of substantive testing which remains in a business risk approach can be undertaken under the balance sheet approach.

In some cases, particularly **small companies**, the business risks may be strongly connected to the fact that management is concentrated in one person. Another feature of small companies may be that their statement of financial position is uncomplicated and contains one or two material items, for example receivables or inventory.

When this is the case, it is **often more cost effective to undertake a highly substantive balance sheet audit than to undertake a business risk assessment**, as it is relatively simple to obtain the assurance required about the financial statements from taking that approach.

10.4.2 Limitations of the balance sheet approach

When not undertaken in conjunction with a risk-based approach or systems testing, the **level of detailed testing** can be high in a balance sheet approach, rendering it **costly**.

11 Information technology and risk assessment

Section overview

- A huge number of organisations now use computer systems to run their businesses and to process financial information.
- The main risks associated with using computerised systems include infection by viruses and access by unauthorised users. Both these risks could potentially have a very damaging effect on the business.
- This means that a number of the controls which the directors are required to put into place to safeguard the assets of the shareholders must be incorporated into the computer systems.
- Auditors have to assess the effectiveness of the controls in place within computer systems and can do this by performing a systems audit as part of their initial assessment of risk during the planning stage of the audit.

11.1 The use of information technology

Most organisations and businesses, even very small entities, now use **information technology (IT)** to some degree. The first use of a computerised accounting system is thought to have been back in 1954 by General Electric, and rapid advances in computer technology since then are allowing companies to conduct business globally, making them indispensable and essential to an entity's operations.

However, the increasing use of computer systems brings with it certain **risks to the business** which can also have an impact on the **risk of the financial statements being misstated**. These risks have increased with the development of the **internet** in the last few years and with it the facility for transactions to be conducted electronically.

One area where IT-driven business risk is growing is the increasing use of **cloud computing**, where digital storage is provided by third parties in remote locations and is only accessible online. Chapter 7 contains more details on cloud computing.

11.2 Risks associated with the use of computerised systems

Cyber-security is becoming an increasingly important issue for businesses to address. The two key **business risks** of organisations using computerised systems are as follows:

- The system being put at risk by a **virus** or some other fault or breakdown which spreads across the system
- The system being **invaded by an unauthorised user**, who could then:
- affect the smooth operation of the system; or
- obtain commercially sensitive information.

Context example: British Airways

In May 2017, IT failures at British Airways resulted in hundreds of flights at Heathrow and Gatwick airports being cancelled and thousands of passengers disrupted. There have been suggestions that the failure could have been avoided if the company had not outsourced its IT work. In 2016 the company made hundreds of its IT staff redundant and outsourced its IT services to India. The failure in May led to planes not being able to take off, baggage not being allowed to move and boarding passes not being able to be issued to passengers.

A few days after the failure, the chief executive of British Airways' parent company stated that the disruption had been caused by an engineer disconnecting a power supply, leading to a power surge when it was reconnected.

Context example: NHS

Also in May 2017, the NHS was affected by a global cyber attack which resulted in patients' operations being cancelled, ambulances being diverted and some patient records being unavailable in England and Scotland. The attack affected not just the UK but almost 100 other countries and originated from malware that was using technology stolen from the National Security Agency in the USA. The malware blocks access to PC files until a ransom is paid, in this case $300. There was no confirmation from the UK government that NHS patient data had been backed up. The attacks used software called WanaCryptor 2.0 or WannaCry which made use of a vulnerability in Windows – Microsoft had issued an update to fix this in March 2017 but not all computers had installed this.

Risks and relevant controls related to cyber-security are dealt with in more detail in Chapter 7.

11.3 Systems audit (IT-specific)

As part of any audit, auditors are required to assess the **quality and effectiveness** of the accounting system. Increasingly, this necessarily includes a consideration of the computer systems in place within the organisation.

The following are the key areas they are likely to concentrate on to establish how reliable the systems are:

- Management policy
- Segregation of duties

- Security

You should be aware that these are important control considerations in a computer environment. The details that the auditor will consider within each area are outlined below.

Management policy

- Does management have a written statement of policy with regard to computer systems?
- Is it compatible with management policy in other areas?
- Is it adhered to?
- Is it sufficient and effective?
- Is it updated when the systems are updated?
- Does it relate to the current system?

Segregation of duties

- Is there adequate segregation of duties with regard to data input?
- Are there adequate system controls (eg, passwords) to enforce segregation of duties?

Security

- Is there a security policy in place?:
  - Physical security (locked doors/windows)
  - Access security (passwords)
  - Data security (virus shields)
- Is it adhered to?
- Is it sufficient and effective?

11.4 Internal controls in a computerised environment

ISA 315 specifically requires the auditor to gain an understanding of the entity's accounting systems and control environment as part of the risk assessment process at the planning stage of the audit. Today, almost any accounting system and control an auditor will encounter will involve some form of IT.

The management policies, segregation of duties and security issues established by the organisation are examples of the internal control activities in a computerised environment. There are two categories of internal controls: general controls and application controls.

General IT controls are the policies and procedures that relate to many IT applications at the same time. They support application controls by maintaining the overall integrity of information and security of data. Examples include procedure manuals, password protection and back-up facilities.

Application controls are manual or automated procedures that typically operate at a business process level and apply to the processing of transactions by individual applications. They are designed to ensure the integrity of the accounting records: that transactions occurred, are authorised, and are completely and accurately recorded and processed. Examples include edit checks of input data and numerical sequence checks with manual follow up of exception reports.

You should already be familiar with these two types of controls from your earlier studies. We will look at them in further detail in Chapter 7.

11.5 Cryptocurrencies and blockchain

To counter the problems of reporting financial performance and position both accurately and securely, a virtual system known as 'blockchain' has become more widespread across the world. Using what is also referred to as a 'distributed ledger', transactions are recorded in blocks, with access and initiation driven by encryption technology. Instead of using a recognised currency, which can be difficult to use online, a virtual currency called 'cryptocurrency' is used within blockchain (one example of this is 'Bitcoin').

Why is this relevant to corporate reporting? You need to be familiar with the technology and how it could be used in a corporate context, including the business risks created from diverting traditional funds into forms of cryptocurrency and how to accurately record, measure and review transactions using such technology. Make sure you revise these terms from your Professional Level Business Strategy and Technology materials.

12 Big data

Section overview

Big data is a broad term for data sets which are large or complex

12.1 Big data

Advances in technology have helped to make data an increasingly important resource in business. Making use of the insights that can be gained from data analysis has made data management a strategic issue for many organisations. The increased emphasis on the importance of data has given rise to the now widely used terms of big data and data analytics (Data analytics is discussed in more detail in section 13). As businesses have changed the way that they use data, auditors have had to respond to the opportunities and challenges that this development has created.

Definition

Big data: A term that describes those "datasets whose size is beyond the ability of typical database software to capture, store, manage and analyse."*(*McKinsey Global Institute, *Big data: The next frontier for innovation, competition and productivity*, 2011*)*.

Today, organisations have access to greater quantities of data than in the past, with vast amounts of transactional data available from a number of internal and external sources, such as suppliers and customers.

The growth in the amount of data now available has been largely fuelled by increasing internet usage and by developments in communication methods such as wireless networks, social media sites and smartphones. An increasing number of organisations have embraced the so-called 'internet of things' by embedding sensor technologies, such as RFID tags (Radio Frequency Identification) and tracking devices, into their operations to gather data from a diverse range of activities. Companies including British Gas, an energy supplier in the UK, have introduced so-called smart meters as a way of measuring the amount of electricity consumers are using on a daily basis. Such meters also allow home owners to better manage their household energy costs as the meter records and wirelessly transmits the level of energy consumption back to the energy provider.

Leading data analytics software firm, SAS, offers the following explanation of big data.

Big data is a term that describes the large volume of data – both structured and unstructured – that inundates a business on a day-to-day basis. But it's not the amount of data that's important. It's what organisations do with the data that matters. Big data can be analysed for insights that lead to better decisions and strategic business moves.

(Source: SAS (n.d.) *Big data – What it is and why it matters*. [Online] Available at: www.sas.com/en_us/insights/analytics/big-data-analytics.html [Accessed 27 May 2022])

12.2 Features of big data

As explained in the ICAEW IT Faculty document *Big data and analytics – what's new?* big data is often characterised by the three Vs:

- Large **volumes** of data
- High-**velocity** data
- Wide **variety** of data

Doug Laney, an analyst with technology research firm Gartner, also suggests that big data can be defined with reference to the three Vs of volume, velocity and variety.

Volume

The vast quantities of data generated are a key feature of big data. Advances in technology and data analytics software have enabled very large data sets to be processed. This is helping organisations to gain a deeper understanding of customer requirements. For example, organisations can collect large amounts of external data about their customers from customers' use of the internet and social media.

This data can now be combined with internally generated data for example, from customer loyalty cards or transactions recorded at shop tills, to build up a more detailed profile of the customer. The volume aspect of big data has challenged the strategic capabilities of many organisations wishing to exploit its potential. Most notably, these have involved enhancing existing IT infrastructures through the use of cloud computing architectures so that they are capable of holding greater amounts of data.

Velocity

Velocity refers to the speed at which 'real time' data flows into the organisation and the speed at which the data is processed by the organisation's systems to produce a meaningful output. Many online retailers have developed capabilities which enable them to record the movements and 'clicks' made by a customer when using the organisation's website. As such, online retailers are now able to build up a better picture of those products and services the customer found most interesting as opposed to only recording the final sale transaction with the customer. Analysing the customers' clicks while still visiting the website has enabled online retailers to recommend relevant additional items for purchase based on those items already viewed. Online websites including Amazon and eBay use this tactic to encourage customers to make extra purchases

Variety

Variety is concerned with the diverse range of forms that big data can take. An increasing amount of data generated comes in an unstructured form, ie, data which is not easy to hold in a database.

Unstructured data may take the form of words used by people on social media sites such as Facebook and Twitter, along with shared content such as photographs or video recordings. Capturing, processing and storing unstructured data presents further challenges to organisations which may need to develop their existing IT/IS capabilities to be able to firstly store such data and secondly extract meaning from the data they hold. Data which is too large, moves too fast or fails to fit neatly with existing IT infrastructures reduces the value which can be derived from it.

The three Vs of big data can also be extended to include an additional characteristic: veracity

Veracity

Veracity (value) is concerned with the truthfulness of the data collected. For data to have any value when being used for decision-making in an organisation, it needs to be truthful, ie, it must not present a bias or contain inconsistencies. The use of poor quality data may have expensive and far reaching consequences for those organisations which rely on it for making strategically important decisions. For example, an organisation may decide to introduce a type of product in the belief that there is sufficient customer demand for it when in reality this may not be the case.

The trend in big data is being propelled by three factors: a growth in computer power, new sources of data and infrastructure for knowledge creation. The combination of these three factors is enabling businesses to use data in ways which were not previously possible or viable. In particular they are using big data to:

- gain insights eg, using more granular data about customers;
- predict the future eg, customer service functions personalise services based on predictions about individual customers; and
- automate non-routine decisions and tasks eg, using machine learning techniques to automate a medical diagnosis.

Like business, auditors have had to respond to the changing environment brought about by big data. Historically auditors have reviewed structured data (eg, transactions recorded in the general ledger) however the analysis of unstructured data can provide new insights (eg, data extracted from emails, texts and social media). Audit firms have invested heavily in recent years in data analytics tools which will enable them to use this data to better understand their clients, identify risks and add value.

13 Data analytics, robotic process automation (RPA) and artificial intelligence (AI)

Section overview

Some firms are currently investing in data analytics to provide a better quality audit and to reduce risk and liability for the auditor. Recent developments in robotic process automation (RPA) and artificial intelligence (AI) have made this kind of technology more sophisticated thus increasing its potential.

13.1 Data analytics

Large firms in particular have been developing a data analytics offering with many clients now expecting their auditors to adopt this approach. However with the growing range of generic data analytics tools becoming available it is also becoming more relevant to small and medium sized firms too.

There are many definitions of data analytics.

Definitions

Data analytics: The process of collecting, organising and analysing large sets of data to discover patterns and other information which an organisation can use for its future business decisions.

Closely linked to the term data analytics is data mining.

Data mining: The process of sorting through data to identify patterns and relationships between different items. Data mining software, using statistical algorithms to discover correlations and patterns, is frequently used on large databases. In essence, it is the process of turning raw data into useful information.

The ICAEW Audit and Assurance faculty document *Data analytics for external auditors* describes data analytics as follows:

"Data analytics involves the extraction of data using fields within the basic data structure, rather than the format of records. A simple example is Power view, an Excel tool which can filter, sort, slice and highlight data in a spreadsheet and then present it visually in variety of bubble, bar and pie charts."

In simpler terms data analytics is about examining raw data with the purpose of drawing conclusions about it. The Audit and Assurance faculty document identifies the following as commonly performed data analytics routines:

- Comparing the last time an item was bought with the last time it was sold, for cost/NRV purposes
- Inventory ageing and how many days inventory is in stock by item
- Receivables and payables ageing and the reduction in overdue debt over time by customer
- Analysis or revenue trends split by product or region
- Analyses of gross margins and sales, highlighting items with negative margins
- Matches of orders to cash and purchases to payments
- 'Can do did do testing' of user codes to test whether segregation of duties is appropriate, and whether any inappropriate combinations of users have been involved in processing transactions
- Detailed recalculations of depreciation of fixed assets by item, either using approximations (such as assuming sales and purchases are mid-month) or using the entire data set and exact dates
- Analyses of capital expenditure v repairs and maintenance
- Three-way matches between purchases/sales orders, goods received/despatched documentation and invoices

Data analytics can also draw on external market data as well as internal data, for example third-party pricing sources and foreign exchange rates can be accessed to recalculate the valuation of investments. ('Coming your way' by Katherine Bagshaw and Phedra Diomidous, *Audit and Beyond*, 2016).

Data analytics can analyse unstructured data as well as structured data. For example an analysis of emails could be a more effective means of identifying fraud than an analysis of journals. Data analytics tools allow the auditor to analyse this type of information in a level of detail which would not be possible manually.

13.2 Improved audit quality

One of the key drivers behind the use of data analytics is improved audit quality. The Audit and Assurance faculty document identifies the following as the unique features of data analytics which contribute to improved risk assessment:

- The ability to graphically visualise results: this makes it easier to drill down to the underlying data and obtain a better understanding of findings

- Sophistication, and the breadth of interrogation options: this includes wide-ranging query and filter options
- Ease of use by non-specialists: the identification of anomalies, outliers and trends could highlight issues that would otherwise have gone unnoticed
- Scale and speed: resulting in time efficiencies

By using data analytics tools the auditor can navigate much bigger data sets much faster than before so that while the analyses performed are not fundamentally different to those performed in the past they are now at a more granular level. The quality of the analyses is enhanced and therefore the judgments made on the basis of this information are enhanced too.

Data analytics can be used to 'drill down' into the data, for example, in order to identify which journals need to be tested. In this way substantive procedures are better directed. For example:

- Extract and examine all credit journal entries to the Revenue Account where the corresponding debit is **not** either receivables or cash (which would be the normal expected entries). These extracted exceptions can then be investigated.
- Extract and examine all journal entries which are: Dr PPE account; Cr an expense account. This would be an unusual entry in the normal course of business and there is a risk of creative accounting by capitalising expenditure that should be expensed. These can be investigated including requiring management explanations.

The Audit and Beyond article also highlights the role of data analytics in supporting the application and demonstration of professional scepticism. For example, predictive data analytics tools might be used to help assess the reasonableness of management representations.

A recent article by KPMG 'Data, Analytics and Your Audit' discusses the impact of big data and how it affects auditors. The article emphasises that the use of data by auditors is not a new thing by any means since auditors have always had to analyse data. Data analytics allows auditors to analyse data at much greater speeds than before. For example, data analytics will allow auditors to sample much higher volumes of transactions up to 100% in some cases, which will allow auditors to identify high risk transactions over a vast array of data and in minutes rather than over weeks. The article cites the example of a clothing retailer and shows how data analytics can allow auditors to evaluate the three- way match between purchase orders, delivery confirmations and invoice documentation in a graphical way that can show account relationships and transaction flows and control issues over segregation of duties. Data analytics can also be used to examine supplier relationships (supplier contracts, payment terms, controls over procurement processes etc).

The article includes a very useful table on the use of data analytics which is shown below.

Area	Use of data analytics
Revenue and accounts receivable	Identify discrepancies in price and quantity between invoices, sales orders and shipping documentation Identifies stockouts and customer orders coming in faster than shipped products

Area	Use of data analytics
Segregation of duties	Identifies areas of increased risk Highlights internal control deficiencies through inefficient segregation of duties
Purchases and accounts payable	Identifies significant or unusual items such as invoice price discrepancies against original purchased products Shows purchase trends and activities with suppliers that are unauthorised or where there are concentrations of spending activities
Supply chain	Identifies risks resulting from the concentration of suppliers in a particular region Can highlight possible issues if suppliers are affected by regional disruptions

13.3 Technical challenges

While data analytics can be seen as the solution to many problems it is also the cause of new ones.

13.3.1 Data capture, extraction, validation and transformation

In order to apply data analytics effectively the auditor needs to be able to extract data from the client's system in a usable format. In order to do so they need to be able to interface with clients' systems. This can involve a considerable amount of investment in mapping different systems, particularly where they are bespoke to the client.

The issue of 'transformation' also has to be addressed. This relates to the way in which data is made useable. This normally involves changing the data by simplifying it. Before changes are made careful thought is required regarding the impact this will have on the quality of the evidence.

13.3.2 Data protection

Confidentiality and security of information are critical issues. This is particularly the case where there is the potential for the creation of new personal data when analyses refer to individuals. In these cases the auditor must ensure that relevant data protection laws and regulations are complied with.

13.3.3 Quality

Data analytics tools must be developed to the highest quality assurance standards. As the Audit and Assurance Faculty document indicates procedures should include pilot and parallel running with the 'normal' audit process together with contingency plans should the software crash. There also need to be proper controls to ensure that individuals using the tools are using them properly.

13.3.4 Data retention

The audit process has always allowed the auditor access to and retention of information which is not its own. However the scope of data analytics is such that the volume has reached a new scale. While there are differing views about the amount of information that should be retained and how long it should be kept there is a consensus that 'If an item has been tested, information about it should be retained such that it could be identified again if necessary'.

13.4 Data analytics and auditing standards

Current auditing standards are risk-based. They require risk analysis, controls testing and sampling against a 'materiality' benchmark. It could be argued that data analytics and its possibilities challenges these concepts and therefore the audit itself. Two aspects of the audit in particular are potentially affected as the technology is developing:

Test of controls

ISAs require evaluation and testing of controls where the auditor is to rely on them, as a means of obtaining comfort that transactions processed by the system are properly recorded in the financial statements. However if auditors are able to use data analytics tools which allow them to see what has happened to all of the transactions and these tools show that they are properly valued and recorded why would the auditor need to test the controls applied in the system?

Sampling

Sampling has historically been adopted on the basis that it is not cost-effective (or necessary if risk assessment has been performed) to audit 100% of all balances in the financial statements. Again data analytics could challenge this principle. For example if it is possible to examine 100% of the invoices automatically, both cheaply and efficiently why would the auditor choose to examine only a sample?

Auditing data analytics

As accountants increasingly use data analytics for the purposes of visualisation, summary and interpretation of ever larger data sets, auditors also need to become more accustomed to using this information in their audits and develop skills that allow them to manage the output of data analytics into their audit approach. Key to this will be unlocking the messages contained in the content created by data analytics techniques. As a student, you should start to consider how you can leverage your professional judgement and scepticism skills when presented with the outcome of data analytics activity.

For example, an auditor may possess software that uses data imported from its client to perform analysis that either applies AI or the auditor's own judgement to highlight trends or anomalies within a population for closer inspection.

13.5 Current developments

13.5.1 IAASB Request for input

The IAASB has set up a Data Analytics Working Group to determine how developments in IT including data analytics might be reflected in new or revised standards. In September 2016 it issued Request for input: Exploring the growing use of technology in the audit, with a focus on data analytics. This aimed to inform stakeholders of the ongoing work by the IAASB in this area, but also to obtain stakeholder input, particularly with respect to whether all of the relevant considerations have been identified.

It makes the following points.

Data analytics and the financial statement audit – benefits

- The quality of the financial statement audit can be enhanced by the use of data analytics.
- The use of data analytics enables the auditor to obtain a more effective and robust understanding of the entity (in an increasingly complex and high volume data environment), improving the application of professional scepticism and professional judgement.
- The auditor is able to obtain audit evidence from the analysis of larger populations.
- The auditor obtains a better insight into the entity and its environment which in turn

provides the entity with additional information to inform its own risk assessment and business operations.

Data analytics and the financial statement audit – limitations

- Auditors need to have a clear understanding of the data they are analysing and in particular the relevance to the audit.
- Being able to test 100% of a population does not change the fact that reasonable assurance is provided.
- The use of data analytics does not replace the need for professional judgement and professional scepticism, particularly in relation to accounting estimates and qualitative information.
- Care must be taken not to have 'overconfidence' in technology ie, adopting the attitude that if a computer software program produced it, it must be right.

Technology and the ISAs

- The ISAs do not prohibit, nor stimulate, the use of data analytics.
- ISAs need to be robust and relevant, however they must be based on principles which drive appropriate auditor performance rather than being tied to current practice or trends.
- Technology solutions can increase the amount of time which auditors can spend on judgemental aspects of analysis as the amount of time spent on manual analysis is reduced.
- There is a current challenge to fit audit evidence derived from data analytics into the current audit evidence model set out in the ISAs.
- A lack of reference to data analytics in ISAs (with the exception of CAATs) may act as a barrier to their adoption more widely.
- The lack of reference in ISAs to data analytics could also suggest that their use does not reduce the procedures required by ISAs, even where these may appear to have been made redundant as a result of the information gained from the use of data analytics.
- Risks arise where new techniques are used for which there is no strong framework within the standards.

Unanswered questions

The IAASB document identifies a number of unanswered questions and challenges.

Data acquisition

Entity data being transferred to the auditor raises security and privacy issues together with storage problems for large volumes of data.

Conceptual changes

The approach, information required and questions asked of the client may be quite different to the traditional approach which may be challenging for the client.

Legal and regulatory challenges

These may relate to data security and potential restrictions on data being transferred from one jurisdiction to another.

Resource availability

There may not be sufficient centralised resources with the required IT expertise to support the engagement teams.

Maintaining oversight

There are challenges for oversight authorities and regulators who may have little experience of data analytics themselves.

Investment in re-training

Training will be required to change the auditor's mind set to that required where data analytics has been used

Next steps

The IAASB states that an evolutionary, rather than revolutionary process should be adopted. ISAs need to take account of the changing technological developments but care must be taken not to commence standard-setting activities prematurely to avoid unintended consequences.

(Source: IAASB (2016) Exploring the Growing Use of Technology in the Audit, with a Focus on Data Analytics [Online]. Available from: www.ifac.org/system/files/publications/files/IAASB-Data-Analytics- WG-Publication-Aug-25-2016-for-comms-9.1.16.pdf [Accessed 27 May 2022])

13.5.2 UK FRC Audit Quality Thematic Review

In January 2017 the FRC issued Audit Quality Thematic Review: The Use of Data Analytics in the Audit of Financial Statements. The purpose of this review was to look at firms' policies and procedures in respect of data analytics and to make comparisons between firms to identify areas of good practice and areas of weakness. The review was based on the use of audit data analytics at the six largest firms in the UK: BDO LLP, Deloitte LLP, Ernst & Young LLP, Grant Thornton UK LLP, KPMG LLP and KPMG Audit plc and PricewaterhouseCoopers LLP.

Use of data analytics

The review document notes that the use of data analytics in the audit is not as prevalent as the market might expect. At the time of the review the only standard tool used widely (ie, accepted norm) by all six firms was journal entry testing. General ledger analysis/third party tools were used regularly (ie, part of the standard auditor 'tool kit') by three firms, with two more using them in a limited capacity. Revenue analytics tools were used widely by one firm and on a limited basis by another whilst derivatives valuation tools were used regularly by one firm only. Process analytics tools and impairment modelling tools were either used on a limited basis or not at all.

Audit quality

The review identified that the use of audit data analytics could improve audit quality in a number of ways including the following:

- Deepening the auditor's understanding of the entity
- Facilitating the focus of audit testing on the areas of highest risk through stratification of large populations
- Aiding the exercise of professional scepticism
- Improving consistency and central oversight in group audits
- Enabling the auditor to perform tests on large or complex data sets where a manual approach would not be feasible
- Improving audit efficiency
- Identifying instances of fraud
- Enhancing communications with audit committees

From its observations of specific applications the Review team observed the following examples of audit data analytics being used to produce good quality audit evidence:

- Tracing individual revenue transactions to debtors and subsequent cash received
- Reproduction of debtors aging
- Valuation of financial instruments
- Tracing supplier income to agreements and cash received
- Recalculation of fund management fees based on value of assets under management

Data capture for use in audit data analytics

The review notes that 'effective and efficient data capture is the key to the successful use of audit data analytics'. At an early stage the audit team needs to ascertain whether the quality of the data that can be provided by the entity's management is sufficient to support the analytic which is to be used. In many instances specialist staff may be used to perform data capture and this may mean that the audit team, the data analytics specialists and the data may be in different geographical locations. This may create issues in relation to data governance, security and privacy.

Appropriate use of audit analytics tools

The Review document states that 'Audit teams need to have a clear understanding of the purpose of the audit data analytics technique to ensure that they obtain sufficient and appropriate audit evidence'. This is of particular relevance at the planning stage of the audit. The Review indicates that the following areas need to be considered when deciding whether to use an audit data analytics tool:

- Whether the tool is a 'good match' for the client's specific environment
- The need to ensure that all relevant assertions are still covered for the balance being tested
- Whether testing in other areas needs to be flexed to provide the necessary supporting evidence for the use of audit data analytics

Evidencing of audit data analytics

The Review emphasises the point that audit documentation should enable an experienced auditor to understand the nature, timing and extent of the audit procedures performed, including where data analytics have been used. In particular it notes that the data analytics specialists must be considered as part of the audit team. Auditing standards in relation to evidence and documentation therefore cover the data analytics specialists' work as they do any other audit work.

13.5.3 Robotic process automation (RPA)

We have already considered the use of RFID chips in the context of big data – imagine how they could be put to use if inventory could be remotely counted and monitored using such technology. This would create savings in terms of staffing required to physically maintain inventory and also those required to process the data from inventory counts, none of whom would ever get sick.

This is just one example of robotic process automation (RPA) where the opportunities to streamline business processes via the use of smart technology are potentially limitless. Clearly, there are also risks attached to such automation, including over-reliance on technology and the structural shift in skills required as finance departments rely more on data analysis than on collection, cleansing and processing. Finance staff need to be trained to operate and review such processes competently.

13.5.4 Artificial intelligence (AI)

Definition

Artificial intelligence (AI): Technology to help improve decisions made by machines, based on machine learning, in an attempt to make better decisions than humans can. AI requires pattern recognition and learning, rather than relying on a series of complex rules, so is not the same as expert systems, which failed to grasp the complexities of the real world and were unable to adapt to dynamic situations. AI systems use complex programming to know how to behave in certain situations, while machine learning promotes automatic learning without being prompted.

Current examples of AI include Amazon's Alexa and Apple's Siri where **small digital devices** are able to respond to voice commands when completing requests such as online searches and connection to other smart devices (such as those that might control lighting and heating in a house). AI and machine learning are also used in various **manufacturing processes** where precision is essential for creating and maintaining competitive advantage.

AI is starting to have more widespread use in driver-less cars and forecasting algorithms for companies. AI needs to consider both forms of decision-making: **intuitive** (based on instincts) and **reasoned** (based on logic). There are similarities to the 'dot com' boom at the start of the 21st century because no-one is really sure how far the possibilities afforded by AI could go.

AI and auditors – opportunities and issues

There is an increasing role of AI as part of **audit data analytics**, in automated and smart auditing of populations, not just samples, thus reducing human error. AI-driven data analytics offer efficiencies, better insight and added value for both accountants and their clients as they can handle large data volumes while the system learns but it will not get tired or make mistakes. AI could support stronger forensic auditing techniques as well (see Chapter 25). Auditors would need to be able to understand the impact of AI and machine learning in the financial statements (such as valuation or impairment for new and emerging technologies, including software).

Accountancy applications exist too, such as increased automation in transaction processes and systems, greater analysis of data to differentiate between 'rogue' (eg, fraud) and 'normal' activity and better predictions and forecasts on complex areas such as revenue.

AI is not 100% perfect though - what about unusual situations with little previous data to use for this machine learning to occur? Currently, while it is in development, AI still requires significant investment to become mainstream and effective and for auditors to be able to direct this AI and interpret its findings.

Nonetheless, there is still great potential (indeed, there may be no choice to adopt once it gains enough traction) which will lead to change and adaptation in the profession: there could be less backward-looking review, and more forward-looking advisory work instead. There could even be scope to determine further uses of AI, such as whether AI can apply **professional scepticism** without a human's judgement present.

13.5.5 Taskforce on Climate-related Financial Disclosures (TCFD)

In March 2020, the Financial Conduct Authority (FCA), which is the main UK financial markets regulator, issued instructions for all UK companies listed on the UK stock market to disclose their **carbon risks** to investors. This would be achieved by companies signing up to the Taskforce on Climate-related Financial Disclosures (TCFD) and disclosing matters such as:

- describing management oversight of risks
- explaining how their strategy would cope in different temperature scenarios

- setting out risk management processes
- reporting their progress against targets

This TCFD approach is endorsed by the UK Government in its Green Finance Strategy (BEIS, July 2019) which outlined the core elements of the recommended climate-related financial disclosures:

Figure 5.7: TCFD

Governance

The organisation's governance around climate-related risks and opportunities

Strategy

The actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy and financial planning

Risk management

The processes used by the organisation to identify, assess, and manage climate- related risks

Metrics and targets

The metrics and targets used to assess and manage relevant climate-related risks and opportunities

According to the government's Green Finance Strategy, 785 organisations now support the TCFD including investors who are responsible for managing assets valued at over £1 trillion.

This comes amid a wider call for **greater corporate transparency** over the sustainability implications of strategies pursued by companies (and indeed countries) as ecological issues continue to dominate public debate. **Investors** in particular have welcomed this transparency as it will allow an informed decision on the steps companies are taking to address the possibility that climate-related issues may affect their return (for example, the risks of flooding affecting crop yields for a food manufacturer).

Clearly, there are **challenges** in how corporate reporting mechanisms can address these requirements, not only for organisations in **collecting and managing the data required** to support these disclosures but also for assurance providers who may be asked to **assess the validity** of such disclosures (whether as part of the audit or otherwise).

In 2021, the UK Government confirmed that with effect from 6 April 2022, the largest UK listed entities and some of the UK's largest private companies would be **required to make climate-related disclosures** that reflect the **TCFD framework** (BEIS, 2021). To this end, the Companies Act 2006 has now been amended specifically to refer to sustainability alongside non-financial disclosures within a company's Strategic Report (UK Government, 2022). The UK's Financial Conduct Authority (FCA) clarified these requirements, stating that from 2022, premium listed companies and issuers of standard listed shares and global depository receipts (GDRs) would be required to make climate- related disclosures in line with the TCFD framework on a '**comply or explain**' basis. UK asset managers, life insurers and FCA-regulated pension providers would not have the option to explain: instead, they would need to make TCFD disclosures at both **entity-level** and in relation to their **products and portfolios** (FCA, 2021). This has since been supplemented by guidance from the FRC on the preparation of the **Strategic Report** in the UK which now includes sustainability and climate- related disclosures for qualifying entities that also reflect the TCFD framework (FRC, 2022).

There is currently **no requirement for these TCFD disclosures to be subject to any specific assurance**, although technically, information of this kind is covered by the auditor's Companies Act 2006 responsibilities for reviewing information in the Strategic and/or Directors' Report, the auditor's responsibilities relating to the UK Corporate Governance Code 'comply or explain' disclosures and those responsibilities that fall under ISA (UK) 720 for the audit of "other information" (TCFD, 2017).

In the UK, the FCA was consulted on the need to mandate assurance for any environmental, social and governance (ESG) disclosures including those related to TCFD, but while **benefits** could be seen, the **cost implications** and the absence of any applicable standards were felt to be obstacles that could not be justified (FCA, 2020).

However, the launch of the **ISSB** and its draft standards on disclosure for sustainability and climate- related risks and opportunities during 2022 may lead to renewed calls for more explicit assurance over ESG information becoming a mandatory requirement.

13.5.6 Guideline on Sustainability and Climate-related Financial Disclosure

In December 2023, Bangladesh Bank, the central bank of the country, issued guidance on sustainability and climate-related Financial Disclosure. Bangladesh Bank has positioned itself as a leading central bank in championing Green & Sustainable finance, actively confronting climate and sustainability risks, and seizing opportunities within the financial sector through strategic policy measures. Recognizing the importance of Sustainability reporting to stakeholders, investors, and development partners, Bangladesh Bank has opted to implement a policy for the financial sector that aligns with the Task Force on Climate-related Financial Disclosures (TCFD) recommendations. This policy aims to provide guidance on Sustainability and Climate-related Financial Disclosures. To address the pressing need for globally accepted sustainability reporting standards that are cohesive, consistent, and comparable to financial reporting standards, the International Financial Reporting Standards (IFRS) Foundation has formed the International Sustainability Standards Board (ISSB). Among the initial standards developed by the ISSB are IFRS S1 and IFRS S2, focusing on sustainability disclosure.

The primary goal of IFRS S1 is to disclose all information pertaining to sustainability-related risks and opportunities, while IFRS S2 outlines disclosure requirements for climate-related financial risks and opportunities. These standards fully integrate the recommendations of the TCFD, aiming to comprehensively capture factors that could reasonably impact a company's future prospects.

Aligned with the aforementioned objectives, Bangladesh Bank released guidelines for banks and financial institutions regarding disclosures concerning sustainability and climate-related risks, utilizing IFRS S1 and IFRS S2 in a phased manner beginning in 2024. The standards issued by the ISSB will empower stakeholders to make informed decisions with assurance. Bangladesh Bank has opted to implement IFRS S1 and IFRS S2 in partnership with the Financial Reporting Council (FRC) of Bangladesh.

Sources: BEIS (2021) *UK to enshrine mandatory climate disclosures for largest companies in law* [Online]. Available at: https://www.gov.uk/government/news/uk-to-enshrine-mandatory-climate- disclosures-for-largest-companies-in-law [Accessed 23 June 2022]

FCA (2020) *Proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations (para. 3.63)* [Online]. Available at: https://www.fca.org.uk/publication/policy/ps20-17.pdf [Accessed 23 June 2022]

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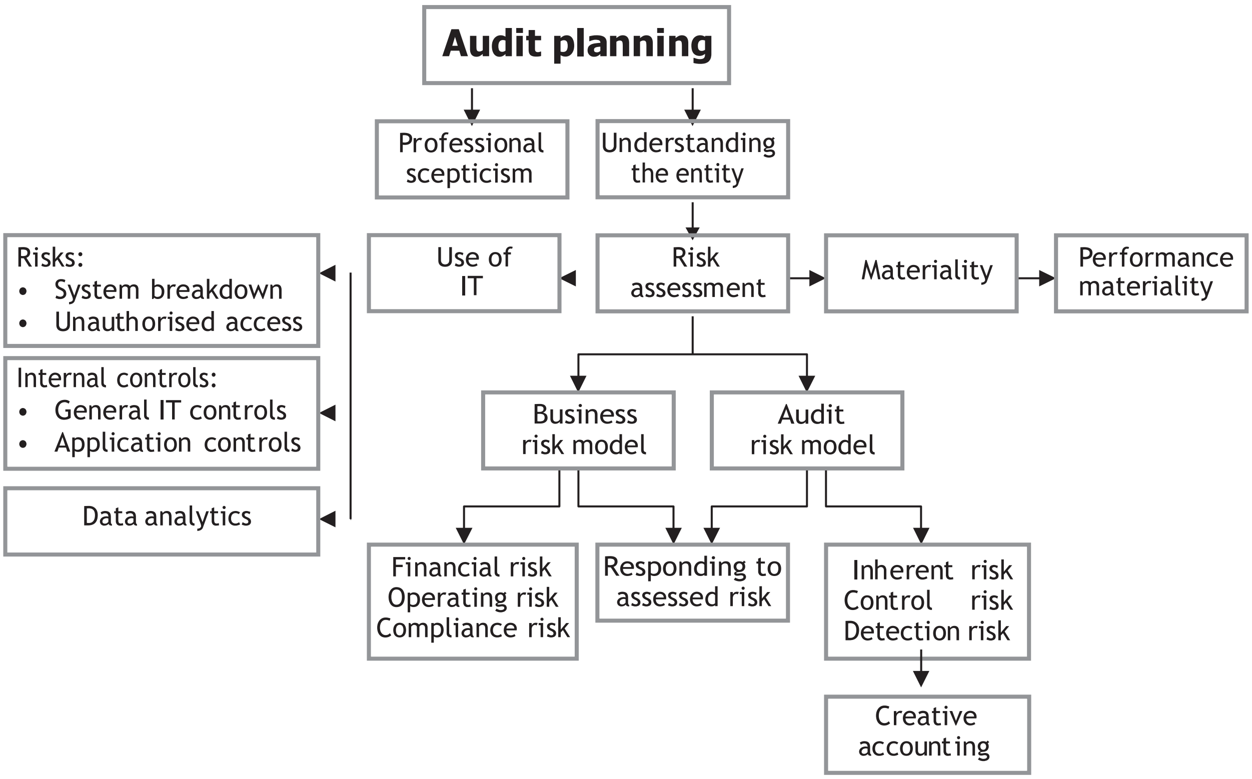
SFD Circular: 06 dated 26 December 2023 issued by Bangladesh Bank

Summary


Audit planning
Professional scepticism
Understanding the entity
Risks:
• System breakdown
• Unauthorised access
Use of IT
Risk assessment
Materiality
Performance materiality
Internal controls:
• General IT controls
• Application controls
Business risk model
Audit risk model
Data analytics
Financial risk
Operating risk
Compliance risk
Responding to assessed risk
Inherent risk
Control risk
Detection risk
Creative accounting

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Can you list the various stages of an audit?
2.	Do you remember the auditing standards (ISAs) relevant to planning and risk assessment?
3.	Can you define professional scepticism and do you know why it matters to auditors?
4.	Do you know which techniques are recommended for an effective understanding of the entity?
5.	Can you explain how business risk is used to help identify areas of misstatement in a set of financial statements?
6.	Do you know the various stages of the audit risk methodology?
7.	Can you explain the term 'creative accounting' and suggest some examples of how it may be present in an audited entity?
8.	Can you define materiality and explain how it should be calculated for a given set of circumstances?
9.	Do you know how the auditor should respond to the assessed level of risk and can you suggest alternative methodologies for the auditor to use?
10.	Are you aware of the following current developments in auditing: information technology; cryptocurrencies and blockchain; big data; data analytics; robotic process automation; and artificial intelligence? Can you explain how each of these developments could impact on the work of the auditor, including the level of audit quality?

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Gates Ltd	An opportunity to see how data analytics could be used in an auditing context.
Suttoner plc	Using a larger scenario, this question asks you to apply the business risk methodology before considering the UK FRC guidance on internal controls.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios that will help you improve your knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Hillhire	Key audit risks and the associated financial statement treatment from a series of issues in a detailed scenario.
Dormro	An integrated scenario question that requires the identification of audit risks in the financial statements.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving on to the next chapter.

Technical reference

1 ISA 210

- Agreement of terms of audit engagements – **ISA 210.9-12**
  - Principal contents of the engagement letter – **ISA 210.10, A23–.27 & Appendix 1**

2 ISA 300

- Preliminary engagement activities – **ISA 300.6**
- Planning activities – **ISA 300.7–.11**
- Documentation – **ISA 300.12**

3 ISA 315 (Revised)

- Risk assessment procedures – **ISA 315.13–.18**
- Understanding the entity and its environment – **ISA 315.19–.27**
- Identifying and assessing the risks of material misstatement – **ISA 315.28–.37**
- Financial statement assertions – **ISA 315.A190**
- Documentation – **ISA 315.38**

4 ISA 320

- Definition of materiality – **ISA 320.2**
- Relationship between materiality and planning – **ISA 320.10–.11**
- Documentation – **ISA 320.14**

5 ISA 330

- Overall responses to risk assessment – **ISA 330.5**
- Response at assertion level – **ISA 330.6–.7**
- Evaluation of sufficiency and appropriateness of evidence– **ISA 330.25-27**

Self-test questions

Answer the following questions.

1 Gates Ltd

You are an audit senior at Bob & Co and have received the following email.

To: Jackie Smith, Audit senior

From: Roy Bob, Audit partner

Subject: Gates Ltd

We are about to take on the audit of Gates Ltd, a wholly owned subsidiary of a US parent company.

Gates Ltd produces computer software for the military for battlefield simulations. It also produces 'off the shelf' software products for other customers. I am concerned about the accounting issues related to these products. Based on the following information, would you please identify and comment on the accounting issues.

The military software usually takes at least three years to develop. The military insists on fixed price contracts. Once the software has been authorised for use by the customer, Gates Ltd supplies computer support services, which are charged on the time spent by the software engineers on site.

The 'off the shelf' packages are not sold to customers, but are issued under a licence giving the right to use the software for a typical period of three years. The licence fee is paid up front by customers and is non-refundable. As part of the licence agreement Gates Ltd supplies maintenance services without additional charge for the three-year period.

Again, based on the above regarding the military software and the 'off the shelf' packages, please can you also set out the audit issues arising.

As a firm we are keen to adopt cutting-edge audit techniques and are in the process of developing data analytics software. I am considering the use of data analytics tools for the audit of Gates Ltd next year and am due to discuss this idea with the audit committee next month. As an IT company itself, the board of Gates Ltd is very interested in this approach. I am putting together some initial thoughts for my meeting and would like you to make some short notes for me, setting out the benefits and challenges of using data analytics as an audit tool.

Requirement

Respond to the partner's email.

2 Suttoner plc

Suttoner plc (Suttoner) operates in the food processing sector and is listed on the London Stock Exchange. You are a member of its internal audit department. The company purchases a range of food products and processes them into frozen or chilled meals, which it sells to major supermarkets in Europe and North America.

The company structure

The company sells food through five subsidiaries, each of which is under the control of its own managing director who reports directly to the main board. Each subsidiary has responsibility for, and is located in, its own sales region. The regions are the UK, the rest of Western Europe, Eastern Europe, the US and Canada. Food is produced in only two subsidiaries, the UK and the US. Head office operates central functions, including the legal, finance and treasury departments.

The board has asked the managing directors of each subsidiary to undertake a risk assessment exercise, including a review of the subsidiary's procedures and internal controls. This is partly due to a review of the company's compliance with the provisions of UK FRC's Guidance on Risk Management,

Internal Control and Related Financial and Business Reporting and also because Suttoner has been severely affected by two recent events and now wishes to manage its future risk exposure.

Recent events

(1) In renegotiating a major contract with a supermarket Suttoner refused to cut its price as demanded. As a result a major customer was lost.

(2) Later in the year the company had been cutting costs by sourcing food products from lower-cost suppliers. In so doing it acquired contaminated pork which made several consumers ill. A major health and safety inspection led to the destruction of all Suttoner's pork inventories throughout Europe, due to an inability to trace individual inventories to source suppliers. More significantly, many supermarkets refused to purchase goods from Suttoner for several months thereafter.

    As a result of these events the company's cash flow was severely disrupted, and significant additional borrowing was needed.

The board's view

In guiding the risk assessment exercise, the board has set clear objectives for subsidiaries to achieve: sales growth, profit growth and effective risk management. Additionally, the board wishes to foster integrity and competence supported by enhancing human resource development.

The board requires managing directors of each subsidiary to report to them annually on these objectives and on internal controls. Otherwise, they have considerable autonomy on pricing, capital expenditure, marketing and human resource management. The UK and US subsidiaries, which process raw foodstuffs, are free to choose their suppliers. The other three subsidiaries may purchase only from the UK or US subsidiaries.

Over a number of years each subsidiary has been managed according to the nature and experience of its managing director, and this has resulted in different styles and levels of control being established locally.

Email from the head of internal audit

To: Joe Lyons

From: Ben Jones

Subject: Risk assessment exercise Joe,

As you know, we are scheduled to update our risk assessment exercise. Can you please take the following on board for me and produce something by Wednesday afternoon?

Firstly, I need you to identify, classify and comment on the key compliance, operating and financial risks to which the company is exposed. On the back of this, can you then draft a note for the finance director to send to the other directors, advising them as to the extent and the likelihood of the three most significant risks identified. For each of these, can you identify appropriate risk management procedures.

Finally, can you draft a note in accordance with the FRC's *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting* (formerly the Turnbull Report) which we can put in our financial statements in relation to 'Control environment and control activities'.

Cheers.

Ben

Requirement

Respond to the email from Ben Jones.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

1.1 The risk is the risk of changes in value of the steel inventory due to changes in the price of the commodity. This is a financial or market risk.

1.2 The auditor would need to consider the following:

- Whether the futures contracts are to be used in a fair value hedge of the steel inventory.
- Whether the required criteria have been met ie, the hedging relationship has been formally designated and the hedge is 'effective'.
- Whether adequate documentation can be produced, including details of:
  - identification of the hedging instrument;
  - the hedged item;
  - nature of the risk being hedged; and
  - how hedge effectiveness will be calculated.
- If hedge accounting is to be used, the risk of incorrect accounting treatment. This risk is increased due to the entity's lack of experience in dealing with this type of transaction.
- Whether the accounting rules of IFRS 9, *Financial Instruments* (or IAS 39 if those rules are applied) have been complied with.

The derivative should be recognised as a financial asset at fair value and any gain recognised in profit or loss.

- The way in which fair value has been established.

Answer to Interactive question 2

Risks/controls/audit procedures

Key risk	Controls to mitigate	Audit procedures
• Failure of internal R&D projects	• Constant monitoring with exit strategies	• Review of failed projects, controls exercised and timing of exit • Write-off of any capitalised R&D
• Excessive expenditure on R&D	• Regular reviews of benefits against costs for each drug, each R&D unit and each period	• Cost-benefit review • Comparison to similar companies • Review of R&D cost control and budgetary procedures
• Insufficient new drugs in the pipeline to sustain profitability	• Monitoring effectiveness of R&D function • Consideration of adequate expenditure levels	• Consider sustained going concern • Review plausibility of alternative strategies

Key risk	Controls to mitigate	Audit procedures
	• Consider alternative strategies (eg, increases in generic drug production) • Alternative uses for existing drugs	
• Development of new drugs by competitors	• Consider effectiveness of patent protection • Consider possibility of licensing • Quantification of effects	• Review patent registration by other companies • Review projected impact on client • Consider writing off any capitalised R&D
• Joint venture failure, disagreement or decline	• Clear contractual rights and obligations • Transparency and communication • Technical monitoring of procedures similar to internal systems above	• Review contractual arrangements and technical progress
• Inadequate financial resources to sustain R&D	• Short-term and long-term financial budgets with actual and contingent financing arrangements	• Consider actual and potential financial resources • Evidence from bankers and other finance providers or their agents
• Changes in health spending or health regulation by governments in major geographical markets	• Monitor political statements and policies • Political lobbying • Consider impacts of changes on profitability	• Review trends in health spending and prospective regulation in key markets • Review client's governmental monitoring procedures and information gained therefrom

Answer to Interactive question 3

Business risks faced by KidsStuff Ltd

- Exposure to foreign exchange risk if imports are not denominated in sterling.
- One major supplier – too reliant on one source.
- Distance from supplier makes resolving production errors more difficult.
- Children's toy market tends to be seasonal – could require significant working capital for periods of the year.
- Strict health and safety rules over children's toys could be breached.
- May be heavily reliant on the skills of Joseph Cooper who will now be close to retirement.
- If unable to keep up with market trends the company will not be able to continue trading.
- Penetration of the computer games market would require significant investment which may not pay off.

- The overdraft is likely to be an expensive form of financing.
- The overdraft could be withdrawn.

Effect of risks on the audit

- The going concern basis of preparation may not be appropriate due to many of the business risks eg, reliance on overdraft.
- Payables, purchases and inventories could all be misstated if incorrect exchange rates are used.
- Exchange gains and losses may be incorrectly accounted for or miscalculated.
- The overseas supplier is likely to have a material payables balance but evidence may be difficult to obtain.
- Importing extends delivery times and makes cut-off more difficult to administer.
- Last year's toys in inventories may well be obsolete.
- Provisions may be required for fines or legal claims in respect of health and safety breaches.
- If the year end is pre-busy season, inventories are likely to be material.
- If the year end is post-busy season, receivables are likely to be material.
- The bank may use the accounts in determining whether or not to renew the overdraft – a duty of care should be considered.
- Neil Cooper may bias the accounts to show an improved performance.

Further information required

- Management accounts for the year to date
- Budgeted results for the year
- Audited financial statements for the previous year(s)
- Correspondence from the bank regarding the overdraft
- Correspondence with the previous auditor regarding: previous audit issues
- Visits to client/notes to ascertain the client's systems
- Trade journals
- Health and safety legislation for the industry
- Minutes of board meetings
- Legal costs and correspondence with solicitors as evidence for litigation risk

Answer to Interactive question 4

Risks associated with accounting treatment include the following.

- **Nature of the contract**

  This contract is essentially a number of goods and services bundled into one contract. This fact adds complexity to the accounting treatment and therefore adds risk. Where the elements can be separated and sold as individual items they should be recognised as if they were independent of each other. In this case it would be possible to sell the handset, access to the network, the call minutes and the texts individually so separate recognition would be appropriate.

- **Revenue recognition policy not in accordance with principles of IFRS 15**

  A distinction will need to be made between the different elements of the package as these are separate performance obligations. Revenue from the sale of the handset should be recognised when this performance obligation has been met. This will normally be at the point that the contract is signed and the customer takes receipt of the handset. Alternatively if the handset is sent to the customer it will be at the point of delivery.

Use of the network would be treated as the rendering of a service. As the service is provided equally over the 12-month period of the contract, the revenue attached to this element should be recognised on a straight-line basis.

The free calls and texts would also be treated as the rendering of a service. However, this service will not necessarily be received on an equal basis each month (as not all free calls/texts may be used each month and may be carried over). The allocation should be based on the best estimate of how the free calls and texts will be used over the life of the contract. This will involve a large amount of estimation which increases audit risk. Where the allocation can be based on historical information eg, average usage on similar packages risk will be reduced

- **Each component of the package may be valued incorrectly**

  The package is effectively a bundle of goods and services with a fair value of £500 sold at a discount of £140 (£500 – £360). If there is a specific discount policy this should be applied to the individual components. For example, the whole of the discount could relate to the handset, in which case the whole of the discount would be deducted from the fair value of the phone. If there is no specific policy an alternative allocation method would be required eg, on a pro rata basis.
  The auditor would need to ensure that the basis used is reasonable.

Answer to Interactive question 5

Audit risks

- **Inherent**
  - Related party transactions/group issues
  - Receivables
  - Fraud – possible indicators, professional scepticism
  - Profit-driven management
  - Credit extended – accounting/law and regulations
- **Control**
  - Lack of segregation of duties
  - PC/virus
  - Suspicion of fraud?
  - Key man
- **Detection**
  - First audit
  - Opening balances and comparatives – audited?

Audit risks – inherent

Related parties and group issues

Forsythia is part of a **complicated group structure**. This raises several issues for the audit:

- There is a risk of related party transactions existing and not being properly disclosed in the financial statements in accordance with IAS 24.
- Similarly, there is a risk that it will be difficult to ascertain the controlling party for disclosure.

- There are likely to be some group audit implications. The firm may be required to undertake procedures in line with the group auditors' requirements if Forsythia is to be consolidated.

Receivables

Forsythia is a **service provider**, and it **extends credit** to customers. This is likely to mean that **trade receivables** will be a significant audit balance. However, there is **limited audit evidence** concerning trade receivables due to the effects of a computer virus. There are also indicators of a **possible fraud**.

Fraud?

There are various factors that may indicate a sales ledger fraud has taken/is taking place:

- Lack of segregation of duties
- Extensive credit offered
- The virus only destroyed sales ledger information – too specific?
- Poorly paid sales ledger clerk – with expensive lifestyle
- Sales ledger clerk is daughter of rich shareholder and they do not have a good relationship

None of these factors necessarily point to a fraud individually, but added together raise significant concerns.

Profit-driven management

Mr Rose is motivated for the financial statements to show a profit for two reasons:

- He receives a commission (presumably sales driven, which impacts on profit).
- He receives dividends as shareholder, which will depend on profits.

There is a risk that the **financial statements** will be **affected by management bias**.

Audit risk – control

There are three significant control problems at Forsythia.

Segregation of duties

There appears to be a **complete lack of segregation of duties** on the three main ledgers. This may have led to a **fraud** on the sales ledger. The fact that there is no segregation on payroll is also a concern, as this is an area where frauds are carried out.

Lack of segregation of duties can also lead to **significant errors** arising and not being detected by the system. This problem means that **control risk** will have to be assessed as **high and substantial substantive testing** be undertaken.

Personal computer

A PC is used for the accounting system. This is likely to have **poor built-in controls** and to further exacerbate the problems caused by the lack of segregation of duties.

The **security** over PCs is also often poor, as has been the case here, where a **virus** has destroyed evidence about the sales ledger.

Key man

The fact that Mr Rose is dominant in management may also be a control problem, as he can override any controls that do exist. There are also risks if he were ever to be absent, as most controls appear to operate through him and there are no alternative competent senior personnel.

Answer to Interactive question 6

Home delivery sales

The appropriate benchmark of materiality with regard to the home delivery sales is revenue, as the home delivery sales form part of the total revenue of the company.

£0.6 million is 1.4% of the total revenue for 20X6 (see W1 below).

An item is generally considered to be material if it is in the region of 1% of revenue, so the home delivery services are material.

Provision

The appropriate benchmark of materiality with regard to the provision is total assets and profit, as the provision impacts both the statement of financial position (it is a liability) and the statement of profit or loss and other comprehensive income (it is a charge against profit).

£0.2 million is 0.65% of total assets in 20X6 (see W2 below). As an item is generally considered to be material if it is in the region of 1–2% of total assets, the provision is not material to the statement of financial position.

However, £0.2 million is 11% of profit before tax for 20X6 (see W3 below). An item is considered material to profit before tax if it is in the region of 5%. Therefore, the provision is material to the statement of profit or loss and other comprehensive income.

WORKING

Materiality calculations

As follows:

(1) (0.6 million ÷ 42.2 million) × 100 = 1.4%

(2) (0.2 million ÷ 30.7 million) × 100 = 0.65%

(3) (0.2 million ÷ 1.8 million) × 100 = 11%

Answer to Interactive question 7

Suitability

- Although the materiality calculation is based on a benchmark commonly used ie, percentage of profit before tax, in this case the resulting figure does not seem appropriate.
- This is due to the fact that the profit figure of the business is volatile (£300,000 in the previous year) and does not seem to be representative of the size of the business in terms of its assets or revenue.
- In instances like this where the company is close to breaking even, total assets or revenue may be a more suitable basis. Alternatively, if profits are to be used, an average figure over a number of years would give rise to a more appropriate materiality balance.
- Materiality as it is currently set is extremely low. The consequence of this is that it would result in substantially increased audit procedures which would be inefficient.

Answers to Self-test questions

1 Gates Ltd

Accounting issues

(1) Military contracts

Long-term contract accounting

The software development should be accounted for under IFRS 15, *Revenue from Contracts with Customers*. Specifically, it is a fixed price contract, ie, where the revenue arising is fixed at the outset of the contract. Under such contracts there is an element of certainty about the revenue accruing, but not about the costs which will arise. For a fixed price contract the contractor should be able to measure reliably the total contract revenues and be able to identify and measure reliably both the costs that have been incurred and those that will be incurred to complete the project. The contractor should also assess whether it is probable that payment will be received under the contract.

As the contracts are fixed price there is an increased risk of the contracts being loss-making, and such losses must be provided for in full.

Computer support

As the amount billed relates directly to the hours spent on site, it would be appropriate to recognise this as revenue when charged.

(2) 'Off the shelf' packages Licence and maintenance costs

An argument could be proposed to recognise this revenue on receipt, given that it is non-refundable, and paid after the development work has been completed and the costs incurred.

However, under IFRS 15, *Revenue from Contracts with Customers* it is generally not appropriate to recognise revenue based on payments received under the contract, as stage payments set out under the terms of the contract often bear little resemblance to the actual services performed. This is a contract in which a performance obligation (the provision of services) is satisfied over time. Revenue relating to the licence should therefore be recognised as the services are provided, ie, as the performance obligation is satisfied.

The maintenance costs should be recognised on a basis that reflects the costs incurred which might be based on the frequency of maintenance calls, probably related to the previous history of maintenance calls.

Audit issues Inherent risks

- Given the nature of the business and the military contracts, physical and electronic security and controls are a major issue.
- Long-term contract accounting involves significant judgements with respect to future contract costs. Judgement increases the likelihood of errors or deliberate manipulation. This area is particularly difficult to audit given the specialised nature of the business, and we will need to ensure that we have personnel with the right experience assigned to the audit.
- There is a risk with long-term contract accounting of misallocation of contract costs – particularly away from loss-making contracts.
- The maintenance provision is an estimate and, again, susceptible to error.

Detection risks

The nature of the military contracts may mean that we are unable to review all the information because of the Official Secrets Act. This could generate a limitation on scope.

Notes re data analytics Benefits

- Enhanced audit quality
- Increased sophistication and breadth of interrogation options
- Enables us to obtain audit evidence from larger populations efficiently
- Analysis at a more granular level enhancing the basis on which judgements are made
- Results in a more effective and robust understanding of the entity improving the application of professional scepticism and professional judgement
- Ability to graphically visualise results increasing ease of use and interpretation
- Provides the entity with additional information to better inform its own risk assessment and business operations

Challenges

- We need to ensure that the development of the software is properly managed so that a high quality audit tool is developed.
- There may be issues with data capture, extraction, validation and transformation.
- Need to consider security and privacy issues together with storage problems for the large volumes of data.
- There may be restrictions on data being transferred from one jurisdiction to another.
- We may have insufficient in-house resources with relevant IT expertise to use the data analytics software and/or to provide central support.
- Need to consider how we use data analytics whilst still complying with the requirements of ISAs (which do not yet address the changes in approach brought about by the use of data analytics).
- The use of data analytics changes the nature of the information required and questions asked of the client. The client may find this challenging.
- We need to ensure that professional scepticism and judgement continue to be applied and that we do not have 'overconfidence' in the technology.

2 Suttoner plc

Identification and classification of risks Compliance risks

Health and safety regulations – Risk of closure of plant and/or destruction of food if contamination arises from purchasing, processing, storing or distribution activities.

Accounting regulations – Need to comply with regulations in several different countries. May need to restate for group accounting purposes to comply with IFRSs if those countries have domestic GAAP that differs from IFRSs.

Taxation – Need to comply with tax regulations, particularly in respect of transfer pricing between divisions in different countries.

Litigation risk – Arising from the possibility of food poisoning. Risks include litigation against the company by those individuals affected and for loss of reputation by supermarkets.

Operating risks

Loss of major customers – Supermarkets may regularly renegotiate contracts and, in so doing, find alternative suppliers. The loss of one such customer this year may be part of a trend.

Power of customers to reduce price – Even where contracts with supermarkets are retained, the renegotiation may be on less favourable terms, resulting in a loss of profits.

Lack of goal congruence by divisional MDs – Significant autonomy at divisional level may mean reduced co-ordination and the pursuit of conflicting goals.

Geographically dispersed supply chain – Given that processing is concentrated in only two centres, there are significant distances involved in the supply chain. This may lead to risks of failure to supply on time and significant low temperature transport and storage costs.

Perishable nature of inventory – The deterioration of perishable food may involve several risks, including inventory valuation, costs of inventory losses and unobserved perishing, which may lead to further food poisoning and loss of reputation.

Measuring divisional performance (arbitrary transfer prices) – There is trade between divisions arising from the supply of distribution divisions from processing divisions. As the companies are separate subsidiaries, there are implications for attesting the profit of individual companies, given the arbitrariness of transfer prices. Moreover, the impact of transfer prices on taxation and their acceptance under separate tax regimes creates additional risk in respect of the taxable profit of separate subsidiaries.

Control systems – The loss of inventory was greater due to the inability to trace the contamination to specific inventories. This deficiency in inventory control systems magnifies any effects from contamination risks of this type.

Generalised food scares – Food scares which are not specific to the company but which arise from time to time may create a reluctance by consumers to purchase some types of the company's product portfolio.

Financial risks

- **Foreign exchange risk** – This includes economic, transaction and translation risk
- **Economic risk** – refers to adverse movements in the exchange rate making goods less competitive in overseas markets or making inputs relatively more expensive
- **Transaction risk** – refers to the situation where in the period between contracting and settlement adverse movements in the exchange rate make the contract less profitable
- **Translation risk** – refers to the risk of the consolidated statement of financial position showing the assets of overseas subsidiaries at a reduced value due to adverse exchange rate movements

Borrowing – gearing risk/liquidity – Increased financial gearing due to the additional borrowing in the year will make future earnings more volatile.

Going concern problems if further contamination scares occur – The loss of business due to the contamination of one of the company's products meant that additional borrowing was needed: this may create questions of going concern if a further incident arises.

Control of financial resources at divisional level – The fact that divisional MDs have significant autonomy has meant that different styles and methods of control have been used. This may be a cause for concern about potential variations in control.

Briefing notes

To: Finance Director

From: Internal auditor

Date: 6 November 20X1
Subject: Extent and likelihood of three key risks

Food scare

Low probability – if appropriate controls are put in place over food quality.

High impact – arising from loss of inventory, loss of reputation, possible loss of contracts/ customers, litigation risk, closure on health grounds.

Proposed course of action – quality control procedures, contingency plans, better inventory identification to locate and minimise infected inventory.

Loss of customer

High probability – assuming that such contracts are being renegotiated on a regular basis. Impact depends on whether:

- sales are concentrated with a few customers;
- new customers can be generated; or
- the loss of customers is systematic, in which case the cumulative impact may be significant.

Proposed course of action – maintain customer relationships, compete on price and non-price issues, develop a wider customer base.

Foreign exchange

High probability – some (and possibly significant) foreign currency movements over time are very likely.

High impact – potentially, the effects of a major currency movement may be significant, although this would depend on the actions taken to moderate such effects. There may also be a favourable currency impact arising from East European currencies becoming more readily acceptable in trading.

Proposed course of action – hedge in the short term (where appropriate and where the cost of doing so is not significant), back to back financing (eg, borrow in US dollars to finance US operations), consider acceptability of East European currencies before significant development in these countries.

Notes to the financial statements

Control environment and control activities

The company is committed to ensuring that a proper control environment is maintained. There is a commitment to competence and integrity, together with the communication of clear objectives to all divisions. These are underpinned by a human resources policy that develops quality with integrity.

The organisational structure has been developed to delegate authority with accountability to ensure that control and consistency are maintained, having regard to an acceptable level of risk. Managing directors report on the control environment on a regular basis to the board. Moreover, the performance of each division is reported and reviewed regularly.

This year the board has undertaken a specific review to assess key risks and to ensure that appropriate information and monitoring is being received.

Chapter 6

The statutory audit: audit evidence

Introduction

Learning outcomes

- Determine analytical procedures, where appropriate, at the planning stage using technical knowledge of corporate reporting, data analytics and skills of financial statement analysis
- Evaluate, where appropriate, the need for, and extent of reliance to be placed on expertise from other parties to support audit processes including when to challenge the extent and working practices of other parties
- Determine, design and develop audit objectives for each financial statement assertion
- Justify and conclude for a particular scenario what comprises sufficient, appropriate audit evidence
- Design and determine audit procedures in a range of circumstances and scenarios, for example identifying an appropriate mix of tests of controls, analytical procedures and tests of details
- Apply professional scepticism to the process of gathering audit evidence and evaluating its reliability including the use of client-generated information and external market information and audit data analytics software
- Design and determine audit procedures in a range of circumstances and scenarios, for example identifying an appropriate mix of tests of controls, analytical procedures and tests of details
- Demonstrate and explain, in the application of audit procedures, how relevant ISAs affect audit risk and the evaluation of audit evidence
- Evaluate, applying professional judgement, whether the quantity and quality of evidence gathered from various audit procedures, including interpreting and extrapolating the results of sampling using appropriate data analysis tools and analytical procedures, is sufficient to draw reasonable conclusions
- Recognise and prioritise using professional judgement on audit issues arising whilst gathering assurance evidence that should be referred to a senior colleague or other specialist

Specific syllabus references for this chapter are: 11(f), 11(i), 14(b)–(g), 14(i)

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	**Revision of assertions** One of the key criteria of good audit evidence is that it is relevant – this is achieved by	**Approach** Use the auditing standards open book to find these assertions and bookmark them for when you need	Focusing on the right assertions will help you to create audit procedures that are relevant for collecting the necessary audit	**IQ1: Financial statement assertions (1)** A good recap designed to refresh your knowledge of assertions.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	the use of assertions which describe the characteristics that items in the financial statements need to possess in order to belong there.	them. **Stop and think** How much of this do you remember from your previous auditing studies?	evidence.	**IQ2: Financial statement assertions (2)** Further practice on assertions using more typical question-based scenarios.
2	**Sufficient, appropriate audit evidence** Evidence is the oxygen without which the auditor cannot breathe – how do we make sure we have enough of the right kind for the audit?	**Approach** This section is mainly revision from your earlier studies but does introduce the use of data analytics as a way of generating audit evidence. **Stop and think** Can you explain the process of triangulation and how it helps to provide audit evidence?	The acid test for any audit evidence is whether or not it ultimately supports the auditor's opinion – when discussing evidence in the exam, you should always be clear about what it is and how it helps the auditors achieve their objectives.	**IQ3: Audit evidence – revision** This is a good recap of the various types of audit evidence that you may come across and why some may be better than others.
3	**Sources of audit evidence** You need to be able to explain the various techniques used by auditors for generating evidence.	**Approach** This should be revision but make sure you can differentiate between tests of control and substantive tests. **Stop and think** Can you tell the difference between tests of detail and substantive analytical procedures?	Exam questions may require you to generate audit procedures in response to a specific issue and that could be driven either by a substantive test or a test of control, so make sure you can describe each one accordingly.	N/A
4	**Selection of audit procedures** This section is essential reading for you – first, you will recap some of the key techniques for	**Approach** Once you have revisited the various procedures, consider how non-current assets could be audited.	Audit procedures need to be specific to score marks in the exam, so learn how to write them in a way that is specific and focused on achieving a particular	**IQ4: Audit procedures revision of tangible assets** This is excellent practice for how to plan an approach for a discrete part of

CHAPTER 6

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	generating evidence and second, consider how these can be applied to specific parts of the financial statements.	**Stop and think** Focus on how procedures are written with a specific assertion in mind.	objective. Remember to design procedures that use appropriate verbs and which justify the use of that procedure in the circumstances.	the financial statements and also how to write suitable audit procedures.
5	**Analytical procedures** This is another significant section in your revision of how to audit – as well as looking at where (and when) analytical procedures are used throughout the audit, you will also learn how to apply these techniques in specific situations (including engagements that fall outside the remit of audit work).	**Approach** While you read through each of these techniques, use the various activities presented as an opportunity to add to your skill set of analytical procedures. **Stop and think** Although very practical and logical, you may still need to display some form of creativity in your use of analytical procedures in order to unlock the messages hidden in the data.	You will definitely need to be able to perform some kind of analytical procedures in your exam (either as part of the audit elements or when analysing a set of financial statements) so you must practise these techniques and be able to manipulate data in order to generate meaningful conclusions.	**IQ5: Analytical procedures (1)** You should note the data that you have been provided with and tailor your approach accordingly. **IQ6: Analytical procedures (2)** As well as making sure you focus on the audit of trade payables, note how software could be used as part of your analysis. **IQ7: Analytical procedures (3)** As well as using these techniques for an audit, you may be asked to appraise an entity's financial health in some way – this is good practice of how to use the same techniques for a different outcome.
6	**Audit of accounting estimates** One of the areas of criticism that auditors are currently facing relates to items in the financial statements where estimates have been	**Approach** Read through this section noting the location of the key terms in the auditing standards open book. **Stop and think** Can you think of	Exam questions could focus on audit procedures where the evidence available may be subject to some form of estimation uncertainty and management bias, so being able to apply	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	included and the auditor has failed to display suitable levels of professional scepticism. ISA (UK) 540 (Revised) is designed to improve the auditor's approach in this area.	some suggested areas of the financial statements where estimates may be particularly common?	some of the guidance suggested here would be required.	
7	**Initial audit engagements – opening balances** As well as the audit risks that arise from all engagements, taking on a new client can also lead to audit risks from their opening balances. What can you do to address this risk?	**Approach** Revisit this material which is revision from your previous studies. **Stop and think** Could you find this standard in the auditing standards open book if required?	Focusing on the given procedures and the information in the appendix will help you to generate suitable audit procedures if required.	N/A
8	**Using the work of others** The auditor may require the use of specialist expertise beyond their own skillset but must ensure it will result in sufficient appropriate audit evidence.	**Approach** You have met experts and internal audit before so make sure you have fully revised this area. **Stop and think** Can you find the necessary ISAs (UK) in your auditing standards open book?	It is possible that the work of either an expert or an internal auditor may be described in an exam scenario – your job is to use the contents of the standards to evaluate the quality of this evidence and identify any shortcomings.	**IQ8: Using an expert – revision** Use this as an opportunity to consider how experts should be used by auditors.
9	**Working in an audit team** Can you explain the hierarchy of roles in an audit team?	**Approach** This is useful to inform you of the various roles in the audit team. **Stop and think** Can you see how each of these roles would help support	Questions may be set which require you to consider the operation of the audit team and to identify possible risks from anyone not performing their role to the best of their ability.	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive questions
		sound quality management?		
10	**Auditing in an IT environment** The use of e-commerce is on the rise – you need to be able to respond accordingly if there is evidence that it is being used in an exam question.	**Approach** Use this section to understand what is meant by e-commerce. **Stop and think** Have you ever been involved in e-commerce?	The content that discusses the considerations for auditors is especially relevant to ensure you use the correct form of terminology.	N/A
11	**Professional scepticism in the audit fieldwork stage** We have already discussed professional scepticism but this section discusses how it can be applied when collecting audit evidence.	**Approach** Work through this section, noting that the worked example will require you to engage with your peers. **Stop and think** Note how the use of data analytics may not always be helpful to the auditor!	As ever, questions will require you to read through everything in the scenario carefully to identify any areas where there could be ambiguity (and as such, could require the need for greater levels of professional scepticism).	N/A
12	**Appendix – External confirmations, sampling and directional testing** Further supporting information on gathering evidence that should be considered revision from your earlier studies.	**Approach** Note the content on external confirmations and sampling and how you can find it in your auditing standards open book. **Stop and think** Also note the use of assertions in directional testing.	While these relate to specific types of evidence gathering techniques, you may still be asked to assess whether audit procedures (which could include anything mentioned here) that are stated in a scenario have been completed appropriately or not.	N/A

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Revision of assertions

Section overview

- Evidence is obtained in respect of each assertion used by the auditor.

1.1 Introduction

As we have seen, **audit work is about reducing risk** – the risk that the financial statements include **material misstatements**. At the most basic level, the financial statements simply consist of the following information about the entity:

- Revenues
- Costs
- Assets
- Liabilities
- Capital

These items will have certain attributes if they are included correctly in the financial statements. These attributes are referred to as **financial statement assertions**.

1.2 Financial statement assertions

Definition

Assertions: The representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatement that may occur.

By approving the financial statements, the directors are making representations about the information therein. These representations or assertions may be described in general terms in a number of ways.

For example, if the statement of financial position includes a figure for freehold land and buildings, the directors are asserting that:

- the property concerned exists;
- it is either owned by the company outright or else the company has suitable rights over it;
- its value is correctly calculated; and
- there are no other items of a similar nature which ought to be included but which have been omitted.
- it is disclosed in the financial statements in a way which is not misleading and is in accordance with the relevant 'reporting framework' eg, international accounting standards.

ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement* states that "the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the **financial statement** and **assertion** levels thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement" (ISA 315.11). It gives examples of assertions in these areas. Depending on the nature of the item, certain assertions will be more relevant than others.

Assertions used by the auditor	
Assertions about **classes of transactions,** events, and **related disclosures**, for the period under audit (ISA 315.A190(a))	**Occurrence**: Transactions and events that have been recorded or disclosed have occurred and pertain to the entity. **Completeness**: All transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included have been included. **Accuracy**: Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described. **Cut-off**: Transactions and events have been recorded in the correct accounting period. **Classification**: Transactions and events have been recorded in the proper accounts. **Presentation**: transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.
Assertions about **account balances, and related disclosures,** at the period end (ISA 315.A190(b))	**Existence**: Assets, liabilities and equity interests exist. **Rights and obligations**: The entity holds or controls the rights to assets, and liabilities are the obligations of the entity. **Completeness**: All assets, liabilities and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included. **Accuracy, valuation and allocation**: Assets, liabilities and equity interests have been included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments have been appropriately recorded and related. **Classification**: Assets, liabilities and equity interests have been recorded in the proper accounts. **Presentation**: Assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

1.2.1 Summary

We have seen that there are 12 assertions applying in different ways to different items in the financial statements.

You can summarise them in the following four questions:

(a) Should it be in the financial statements at all?

(b) Is it included at the right amount?

(c) Are there any more?

(d) Has it been properly disclosed and presented?

The following table shows how the assertions fit with these questions:

	Transactions, events and related disclosures	**Account balances and related disclosures at the period end**
Should it be in the accounts at all?	Occurrence Cut-off	Existence Rights and obligations
Is it included at the right amount?	Accuracy	Accuracy, valuation and allocation
Are there any more?	Completeness	Completeness
Is it properly disclosed and presented?	Classification Presentation	Classification Presentation

Interactive question 1: Financial statement assertions (1)

Complete the table below.

- Identify procedures to satisfy the four key questions.
- Identify the financial statement assertions that these procedures will satisfy.

Audit area	Key question	Examples of procedures	Assertions
Non-current assets	Should it be in the accounts at all?	Physically verify	Existence Rights and obligations
	Is it included at the right amount?	Inspect invoices/contracts Check depreciation	Accuracy, valuation and allocation
	Are there any more?		
	Is it properly disclosed and presented?		
Receivables	Should it be in the accounts at all?		
	Is it included at the right amount?		
	Are there any more?		
	Is it properly disclosed and presented?		

Audit area	Key question	Examples of procedures	Assertions
Payables	Should it be in the accounts at all?		
Payables	Is it included at the right amount?		
	Are there any more?		
	Is it properly disclosed and presented?		
Inventory	Should it be in the accounts at all?		
	Is it included at the right amount?		
	Are there any more?		
	Is it properly disclosed and presented?		

See **Answer** at the end of this chapter.

Interactive question 2: Financial statement assertions (2)

For the following points, identify and explain the most relevant financial statement assertions. Assume that the year end is 31 December 20X7 in each case.

2.1 Fine plc is proposing to award share options to five directors. The proposal is to issue 100,000 options to each of the five individuals on 1 September 20X7 (the grant date) at an exercise price of £7 per share. The scheme participants will need to have been with the company for at least three years before being able to exercise their options. It is believed that all the directors will satisfy this condition. Other relevant information is as follows:

	1 September 20X7	31 December 20X7
	£	£
Market price per share	7.00	8.20 (estimated)
Fair value of each option	3.00	5.70 (estimated)

2.2 Wiggam plc has purchased goods worth £750,000 from Tepid Ltd on an arm's length basis. Wiggam owns 40% of the ordinary share capital in Tepid.

2.3 Deakin plc issued 10,000 6% convertible bonds at par value of £10 on 31 December 20X7. On this date the market interest rate for similar debt without the option to convert was 10%. Each bond is convertible into four ordinary shares on 31 December 20X9.

See **Answer** at the end of this chapter.

2 Sufficient, appropriate audit evidence

Section overview

- Auditors need to obtain sufficient, appropriate audit evidence.

2.1 Importance

ISA 500, *Audit Evidence* states that the objective of the auditor is to obtain sufficient, appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

The importance of obtaining sufficient, appropriate audit evidence can be demonstrated in the Arthur Andersen audit of Mattel Inc.

Context example: Mattel Inc

This is a complex case but in simple terms Mattel Inc inflated its reported earnings by using a technique which came to be known as 'bill and hold'. This involved billing customers for future sales. While the sale was recorded immediately (with invoices often prepared without the knowledge of the customer) the merchandise was not shipped. To support these sales Mattel produced false sales orders, invoices and bills of lading. The bills of lading were signed by employees as both themselves and the carrying company. They were then stamped 'bill and hold'. Problems which arose when the goods were actually sold were dealt with by making other fraudulent entries in the books.

When Arthur Andersen audited accounts receivable they sent accounts receivable confirmations to customers. These were returned with many substantial discrepancies due to the 'bill and hold' entries. As part of the reconciliation process the auditors reviewed copies of bills of lading to serve as confirmation that the goods had been shipped. However, the auditors did not question the term 'bill and hold' even though it was clearly stamped on the documents and did not appear to notice that the same individual had signed as both representatives of Mattel Inc and the shipping company. A number of entries were questioned and the audit senior who reviewed the working papers noted that additional explanations were required but no further investigation actually took place.

(Source: Hayes, R., Dassen, R., Schilder, A., Wallage, P. (2005) Principles of Auditing: An Introduction to International Standards on Auditing. 2nd Ed. England: Pearson Education Limited)

2.2 Sufficient and appropriate evidence

'Sufficiency' and 'appropriateness' are **interrelated** and apply to both tests of controls and substantive procedures.

Sufficient evidence relates to the **quantity** of evidence gathered. However, it is not simply a question of 'more is better', as different sources can be more or less persuasive. Broadly speaking, however, it is possible to say that the greater the risk of misstatement, the greater the quantity of evidence required.

However, the standards are clear that if the auditor decides to perform more comprehensive testing eg, by selecting a bigger sample the extra work must contribute to the reduction of risk.

Appropriateness relates to the **quality** of evidence. ISA 0 amplifies this term by saying that evidence should be:

- **relevant**
- **reliable**

Relevance deals with the logical connection with the purpose of the audit procedure and, where appropriate, the **assertion** under consideration.

Reliability is **influenced by the source and nature of the evidence**; however, you should be familiar with the following generalisations from your earlier studies:

- Audit evidence is **more reliable** when it is obtained from **independent sources** outside the entity.
- Audit evidence that is generated **internally** is more reliable when the related controls imposed by the entity are **effective**.
- Audit evidence obtained **directly by the auditor** (for example, observation of the application of a control) is **more reliable** than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- **Documentary evidence** is **more reliable**, whether paper, electronic or other medium (for example, a written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
- **Original documents** are **more reliable** than photocopies or faxes.

2.2.1 Audit data analytics

The UK FRC Audit Quality Thematic Review: The Use of Data Analytics in the Audit of Financial Statements indicates a number of issues which need to be considered at the planning stage of the audit which relate to sufficiency and appropriateness of audit evidence. These are as follows:

- Considering whether a tool is a 'good match' for the client's specific environment
- Ensuring that all relevant assertions are covered
- Whether testing in other areas needs to be flexed to provide the necessary supporting evidence for the use of audit data analytics
- The UK FRC Review was covered in more detail in Chapter 5.

The issue of reliability of data also needs to be re-assessed as data analytics includes the interrogation of a wider range of sources of information than might have traditionally been the case. For example expectations regarding reliability relating to information generated by the client's accounting system will be different to those relating to the reliability of information generated by analytics procedures performed on emails.

Interactive question 3: Audit evidence – revision

"The objective of the auditor is to […] obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion." (ISA 500.4)

Requirements

Discuss the extent to which each of the following sources of audit evidence is appropriate and sufficient.

3.1 Oral representation by management in respect of the completeness of sales where the majority of transactions are conducted on a cash basis.

3.2 Flowcharts of the accounting and control system prepared by a company's internal audit department.

3.3 Year-end suppliers' statements.

3.4 Physical inspection of a non-current asset by an auditor.

3.5 Comparison of revenue and expenditure items for the current period with corresponding information for earlier periods.

3.6 A proof in total calculation performed by the auditor to validate the interest expense relating to a bank loan.

See **Answer** at the end of this chapter.

2.3 The work of a management's expert as audit evidence

Definition

Management's expert: An individual or organisation possessing expertise in a field other than accounting or auditing whose work in that field is used by the entity to assist the entity in preparing financial statements.

Certain aspects of the preparation of financial statements may require expertise such as actuarial calculations (relevant to accounting for pensions) or valuations (where the fair value alternative is used for non-current assets). The entity may employ such experts or may engage the services of external experts. ISA 500 includes guidance on the considerations that arise for the external auditor in using this information as audit evidence.

If this work is significant to the audit the external auditor shall:

- evaluate the competence, capabilities and objectivity of the expert;
- obtain an understanding of the work of the expert; and
- evaluate the appropriateness of the expert's work as audit evidence for the relevant assertion.

Note: Situations where the external auditor requires the assistance of an expert in obtaining audit evidence are covered by ISA 620, *Using the Work of an Auditor's Expert* (see later in this chapter).

2.4 Triangulation

Forming an audit opinion is a question of using **professional judgement** at all times and judgements have to be made about the nature, the quality and the mix of evidence gathered. It is also essential that individual items of evidence are not simply viewed in isolation but instead support other evidence and are supported by other evidence. This approach views evidence from different sources as predominantly complementary, rather than compensatory. This strategy of acquiring and evaluating **complementary** evidence from a range of sources is referred to as **triangulation.** This approach is an application of the general principle that evidence obtained from different sources, that presents a consistent picture, is mutually strengthening and gives greater reliance than merely increasing the amount of evidence from a single source. The consequence of overreliance on one specific type and source of evidence can be seen in the case of the collapse of Parmalat.

Professional skills focus: Assimilating and using information

Scenarios are always presented in such a way as to require analysis of all the available information, which is only possible once you have reviewed everything in the question.

Mastering this process of triangulation is a key part of being able to make the best use of the information at your disposal.

Context example: Overreliance on confirmations

One of the largest examples of overreliance on one type of audit confirmation was the Parmalat collapse of 2003.

Parmalat Finanziaria Spa is an Italian-based company. Its main operating subsidiary Parmalat Spa dealt with dairy produce around the world. On 24 December 2003 Parmalat Spa filed for bankruptcy. How could this happen to a company that employed 36,000 employees, operated in 30 countries and was Italy's biggest food maker? The answer is simply forged documentation!

Parmalat allegedly had €3.95 billion worth of cash and marketable securities in an account at the Bank of America but under the name of Bonlat Financing Corporation. In 2002 Grant Thornton, the auditors of Bonlat, had requested confirmation of the balances from Bank of America. Three months later a reply was received by post, not fax, confirming the balance. It later transpired that this letter was a forgery and Bank of America confirmed this in a press release. The Parmalat CEO left Italy on the day of this press release. The €3.95 billion worth of cash and securities simply did not exist.

In retrospect, additional evidence rather than simply one (forged) letter should have been obtained for the cash balance. The case shows that even external confirmations and letters from other auditors should be treated with some scepticism where the amounts involved are very material.

(Source: Hayes, R., Dassen, R., Schilder, A., Wallage, P. (2005) Principles of Auditing: An Introduction to International Standards on Auditing. 2nd Ed. England: Pearson Education Limited)

3 Sources of audit evidence

Section overview

Sources of audit evidence include:

- Tests of controls (covered in Chapter 7)
- Substantive procedures

3.1 Tests of controls

You will have covered **tests of controls** in your earlier studies. We cover evaluation of controls and tests of controls in more detail in Chapter 7; however, a key point to remember is even if evaluated and tested controls are considered strong enough to rely on, there is still a need to carry out some substantive testing.

3.2 Substantive procedures

ISA 330, *The Auditor's Responses to Assessed Risks* states that irrespective of the assessed risk of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance and disclosure.

There are two key types of substantive procedure.

- **Substantive analytical procedures**. These are generally more applicable to large volumes of transactions that tend to be predictable over time. We will look at these in detail in section5.
- **Tests of details**. These are ordinarily more appropriate to obtain audit evidence regarding certain assertions about account balances. We will see how these are applied to key aspects of the financial statements as we work through the remainder of the chapter.

4 Selection of audit procedures

Section overview

Methods of obtaining audit evidence include:

- inquiry
- observation
- inspection
- recalculation
- reperformance
- external confirmation
- analytical procedures

The procedures used are selected according to the nature of the balance being audited and the assertion being considered. Audit procedures may be carried out using data analytics tools as discussed in Chapter 5.

4.1 Types of procedure

Auditors obtain evidence by using one or more of the following procedures.

4.1.1 Inquiry

Definition

Inquiry: Consists of seeking information of knowledgeable persons both financial and non-financial within the entity or outside the entity.

Examples

Inquiry includes obtaining responses to formal written questions and asking informal questions in relation to specific audit assertions. The response to inquiries provides the auditor with information that was not previously possessed or may corroborate information obtained from other sources. The strength of the evidence depends on the knowledge and integrity of the source. Where the result of inquiry is different from other evidence obtained, then reasons for that difference must be sought and the information reconciled.

Business focus

Common uses of inquiry are as follows:

- Written representations – where management have information not available from any other source

- Asking employees about the internal control systems and effectiveness of the controls they are operating

Remember it is not normally sufficient to accept inquiry evidence by itself – some corroboration will be sought. The US court case of *Escott et al. v Bar Chris Corporation1968* ruled that the auditor was negligent in not following up answers to management inquiries. The judge indicated that the auditor was too easily satisfied with glib answers and that these should have been checked with additional investigation.

4.1.2 Observation

Definition

Observation: Consists of looking at a procedure or process being performed by others.

Examples

Observation is not normally a procedure to be relied on by itself. For example, the auditor may observe a non-current asset, such as a motor vehicle. However, this will only prove the vehicle exists; other assertions such as rights and obligations will rely on other evidence such as invoices and valuation possibly on the use of specialist valuers or documentation.

Business focus

Observation is commonly used in the business processes of inventory management. After inventory has been purchased, an organisation holds raw materials, work in progress and finished goods in its warehouses and factories. Observation is used to determine that the inventory exists, it is valued correctly (looking for old and slow-moving inventory) and that inventory is complete in the organisation's books. Note the link to audit assertions here.

Additionally, the auditor will be observing the internal control systems over inventory, particularly in respect to perpetual inventory checking and any specific procedures for year-end inventory counting. You should be familiar with the audit procedures in respect of attendance at an inventory count from your Assurance studies.

Observation may also be used in the human resource business process. The auditor will observe employees operating specific controls within the internal control system to determine the effectiveness of application of those controls, as well as the ability of the employee to operate the control. However, the act of observing the employee limits the value of the evidence obtained; many employees will amend their work practices when they identify the auditor observing them.

4.1.3 Inspection

Definition

Inspection: Means the examination of records, documents or tangible assets.

Examples

By carrying out inspection procedures, the auditor is substantiating information that is, or should be, in the financial statements. For example, inspection of a bank statement confirms the bank balance for the bank reconciliation which in turn confirms the cash book figure for the financial statements.

Business focus

Inspection assists with the audit of most business processes. For example:

- Financing: inspection of loan agreements to confirm the term and repayment details (part of the completeness of disclosure in the financial statements)
- Purchasing: inspection of purchase orders to ensure that the order is valid and belongs to the company (occurrence assertion among others)
- Human resources: inspection of pay and overtime schedules as part of wages audit
- Inventory management: inspection of the work in progress ledger confirming cost allocation to specific items of work in progress (valuation assertion)
- Revenue: inspection of sales invoices to ensure that the correct customer has been invoiced with the correct amount of sales (completeness and accuracy assertions)

Inspection of assets that are recorded in the accounting records confirms **existence**, gives evidence of **valuation**, but does not confirm **rights and obligations**.

Confirmation that assets seen are recorded in accounting records gives evidence of **completeness**. Confirmation to documentation of items recorded in accounting records confirms that an asset **exists** or a transaction **occurred**. Confirmation that items recorded in supporting documentation are recorded in accounting records tests **completeness**.

Cut-off can be verified by inspecting the reverse population; that is, checking transactions recorded **after** the end of the reporting period to supporting documentation to confirm that they occurred after the end of the reporting period.

Inspection also provides evidence of **valuation/accuracy**, **rights and obligations** and the nature of items **(presentation and classification)**. It can also be used to **compare** documents (and hence test **consistency** of audit evidence) and confirm **authorisation**.

CHAPTER 6

4.1.4 Recalculation

Definition

Recalculation: Consists of checking the arithmetical accuracy of source documents and accounting records.

Examples

Recalculation obviously relates to financial information. It is deemed to be a reliable source of audit evidence because it is carried out by the auditor.

Business focus

Recalculation relates to most business processes. For example:

- Financing: calculation of interest payments
- Purchasing: accuracy of purchase orders and invoices
- Inventory management: valuation of work in progress
- Revenue: recalculation of sales invoices

Recalculation is particularly effective when carried out using **computer-assisted audit techniques** (CAATs), as the computer can perform the whole of the inventory calculation (for example) in a short time period. Data analytics may also be used. For example data analytics routines may be used to perform detailed recalculations of depreciation on non-current assets by item. Approximations could be used (eg, assuming sales and purchases are mid-month) or by using the entire data set and exact dates.

4.1.5 Reperformance

Definition

Reperformance: Means the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

Examples

Auditors will often reperform some of the main accounting reconciliations, such as the bank reconciliation or reconciliations of individual supplier balances to supplier statements. It is also deemed to be a reliable source of audit evidence because it is carried out by the auditor.

Business focus

Reconciliations are a key control over many transaction cycles in the business, and if performed properly are an effective means of identifying accounting errors or omissions. If they are performed by an individual who is not involved in the day to day accounting for the underlying transactions they can be a deterrent against fraudulent accounting.

4.1.6 External confirmation

Definition

External confirmation: Audit evidence obtained as a direct written response to the auditor from a third party.

Examples

A typical example of confirmation evidence is obtaining a response from a debtors' circularisation (see Appendix for revision on this area). The evidence obtained is highly persuasive, as it comes from an independent external source.

Key characteristics of any confirmation are as follows:

- Information is requested by the auditor.
- The request and response are in writing and the response is sent direct to the auditor.
- The response is from an independent third party.
- The confirmation is usually required to be positive (a response is expected) rather than negative (a non-reply is assumed to confirm information provided to the third party).

Business focus

Confirmations are normally used in the following business processes:

- Financing: agreement of bank balances, loan amounts outstanding etc, (see Appendix)
- Inventory: confirmation of inventory held at third parties
- Revenue: confirmation of amounts due from debtors and payable to creditors (see Appendix)

4.1.7 Analytical procedures

We will look at these in a later section.

4.2 Application of procedures to specific areas of the financial statements

You should be familiar with the basic principles behind the audit of key balances in the financial statements from your Assurance studies. This section demonstrates the application of these principles, looking in particular at non-current assets.

4.2.1 Tangible assets

The major risks of misstatement in the financial statements are due to:

- expenses being capitalised as non-current assets (**existence** assertion);
- tangible assets being carried at the wrong cost or valuation (**accuracy, valuation and allocation**
assertion);
- tangible assets being carried at the wrong cost or valuation due to charging inappropriate depreciation, or not depreciating (**accuracy, valuation and allocation** assertion); and
- tangible assets being carried at the wrong cost or valuation due to impairment reviews not being carried out appropriately (**accuracy, valuation and allocation** assertion).

Interactive question 4: Audit procedures revision of tangible assets

Your firm acts as auditors to Xantippe Ltd, a manufacturer of industrial components. You have been presented with the financial statements for the year to 31 December 20X6, which include the following information in connection with property, plant and equipment.

	At 1 January 20X6	**Additions**	**Disposals**	**At 31 December 20X6**
	£	**£**	**£**	**£**
Cost				
Freehold property	80,000	–	–	80,000
Plant and machinery	438,000	62,000	(10,000)	490,000
Motor vehicles	40,500	13,000		53,500
	558,500	75,000	(10,000)	623,500

	At 1 January 20X6	**Charge for year**	**Disposals**	**At 31 December 20X6**
	£	**£**	**£**	**£**
Depreciation				
Freehold property	8,000	1,600	–	9,600
Plant and machinery	139,500	47,000	(3,000)	183,500
Motor vehicles	20,000	10,200		30,200
	167,500	58,800	(3,000)	223,300

Requirements

4.1 Explain the factors that should be considered in determining an approach to the audit of property, plant and equipment of Xantippe Ltd.

4.2 State the procedures you would perform in order to reach a conclusion on property, plant and equipment in the financial statements of Xantippe Ltd for the year ended 31 December 20X6.

See **Answer** at the end of this chapter.

Impairment of non-current assets

An asset is **impaired** when its **carrying amount** (depreciated cost or depreciated valuation) **exceeds** its **recoverable amount**. Management are required to determine if there is any **indication** that the assets are impaired.

The auditors will consider whether there are any **indicators of impairment** when carrying out **risk assessment procedures**. They will use the same impairment criteria laid out in IAS 36, *Impairment of Assets* as management do. If the auditors believe that impairment is indicated, they should request that management show them the impairment review that has been carried out. If no impairment review has been carried out, then the auditors should discuss the need for one with management and, if necessary, modify their report on grounds of disagreement (not conforming with IAS 36) if management refuse to carry out an impairment review.

If an impairment review has been carried out, then the auditors should audit that impairment review. Management will have estimated whether the recoverable amount of the asset/cash generating unit is lower than the carrying amount.

For auditors, the key issue is that **recoverable amount requires estimation**. As estimation is subjective, this makes it a risky area for auditors.

Management have to determine if recoverable amount is higher than carrying amount. It may not have been necessary for them to estimate both fair value and value in use because, if one is higher than carrying amount, then the asset is not impaired. If it is not possible to make a reliable estimate of net realisable value, then it is necessary to calculate **value in use**. Net realisable value is only calculable if there is an **active market for the goods**, and would therefore be audited in the same way as fair value. Costs of disposal such as taxes can be recalculated by applying the appropriate tax rate to the fair value itself. Delivery costs can be verified by comparing costs to published rates by delivery companies, for example, on the internet.

If management have calculated the value in use of an asset or cash-generating unit, then the auditors will have to **audit that calculation**. The following procedures will be relevant.

Value in use

- Obtain management's calculation of value in use.
- Reperform calculation to ensure that it is mathematically correct.
- Compare the cash flow amounts to recent budgets and projections approved by the board to ensure that they are realistic.
- Calculate/obtain from analysts the long-term average growth rate for the products and ensure that the growth rates assumed in the calculation of value in use do not exceed it.
- Refer to competitors' published information to compare how much similar assets are valued at by companies trading in similar conditions.
- Compare to previous calculations of value in use to ensure that all relevant costs of maintaining the asset have been included.
- Ensure that the cost/income from disposal of the asset at the end of its life has been included.
- Review calculation to ensure cash flows from financing activities and income tax have been excluded.
- Compare discount rate used to published market rates to ensure that it correctly reflects the return expected by the market.

If the asset is impaired and has been written down to recoverable amount, the auditors should review the financial statements to ensure that the write-down has been carried out correctly and that the IAS 36 disclosures have been made correctly.

4.2.2 Intangible assets

Accounting guidance for intangibles is given in IAS 38, *Intangible Assets* and IFRS 3, *Business Combinations*. The types of assets you are likely to encounter under this heading include the following:

- Patents
- Licences
- Trademarks
- Development costs
- Goodwill

The major risks of misstatement in the financial statements are due to:

- expenses being capitalised as non-current assets (**existence** assertion);
- intangible assets being carried at the wrong cost or valuation (**accuracy, valuation and allocation** assertion);
- intangible assets being carried at the wrong cost or valuation due to charging inappropriate amortisation, or not amortising (**accuracy, valuation and allocation** assertion); and
- intangible assets being carried at the wrong cost or valuation due to impairment reviews not being carried out appropriately (**accuracy, valuation and allocation** assertion).

In order to address these, the auditor should carry out the following procedures.

Completeness

- **Prepare analysis** of movements on cost and amortisation accounts.

Rights and obligations

- **Obtain confirmation** from a patent agent of all **patents** and **trademarks** held.
- **Verify payment** of **annual renewal fees**.

Accuracy, valuation and allocation

- **Review specialist valuations** of intangible assets, considering:
  - qualifications of valuer
  - scope of work
  - assumptions and methods used
- **Confirm that carried down balances** represent **continuing value**, which are proper charges to future operations.

Additions (rights and obligations, valuation and completeness)

- Inspect purchase agreements, assignments and supporting documentation for intangible assets acquired in period.
- Confirm that purchases have been authorised.
- Verify amounts capitalised of patents developed by the company with supporting costing records.

Amortisation

- **Review amortisation**
  - Check computation
  - Confirm that rates used are reasonable

Income from intangibles

- **Review sales returns** and **statistics** to verify the reasonableness of income derived from patents, trademarks, licences etc.
- **Examine audited accounts** of third-party sales covered by a patent, licence or trademark owned by the company.

Professional skills focus: Structuring problems and solutions

The requirements of a question will often need some further work to fully understand what the examining team is looking for, especially when requesting audit procedures in relation to a stated exhibit. Good awareness of the various types of procedure and when they should be used will help you make sense of what you have been asked to do.

5 Analytical procedures

Section overview

- Analytical procedures are used as part of risk assessment and are required to be used as part of the final review process.
- Analytical procedures may be used as substantive procedures.

5.1 Use of analytical procedures

Analytical procedures are used throughout the audit.

- ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement* deals with their use as **risk assessment** procedures.
- ISA 520, *Analytical Procedures* **requires** that analytical procedures are used **near the end of the audit** when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

Analytical procedures **may** also be used as **substantive procedures**.

Auditors should not normally rely on analytical procedures alone in respect of material balances but should **combine them with tests of detail**.

However, ISA 330 paragraph A43 points out that the combination will depend on the circumstances, and that the auditor may determine that performing only analytical procedures will be sufficient to reduce audit risk to an acceptably low level; for example, where the auditor's assessment of risk is supported by audit evidence from tests of controls.

This is an area of the audit where the use of data analytics tools can be particularly effective, in support of judgements and providing greater insights. Data analytics tools are able to draw on a wider range of data as compared to traditional methods. For example interest and foreign exchange rates, changes in GDP and other growth metrics could be used. External market data may also be relevant.

Professional skills focus: Structuring problems and solutions

Remember that as well as any quantitative data presented in the exam question, there will also be information from the data analytics software that you will need to consider as part of your approach.

5.2 Practical techniques

Ratio analysis is one of the key techniques which the auditor will use when performing analytical procedures. You have looked at the relevant ratios in detail in your Assurance studies. A brief summary is provided below.

5.2.1 Ratio analysis

When carrying out analytical procedures, auditors should remember that every industry is different and each company within an industry differs in certain aspects.

Important accounting ratios	Gross profit margins, in total and by product, area and months/quarter (ifpossible) Receivables ratio (average collection period) Inventory turnover ratio (inventory divided into cost of sales) Current ratio (current assets to current liabilities) Quick or acid test ratio (liquid assets to current liabilities)Gearing ratio (debt capital to equity capital) Return on capital employed (profit before interest and tax to total assets less current liabilities)
Related items	Payables and purchases Inventory and cost of sales Non-current assets and depreciation, repairs and maintenance expense Intangible assets and amortisation Loans and interest expense Investments and investment income Receivables and irrecoverable debts expense Receivables and sales

Ratios mean very little when used in isolation. They should be calculated for **previous periods** and for **comparable companies**. The permanent file should contain a section with summarised accounts and the chosen ratios for prior years.

In addition to looking at the more usual ratios the auditors should consider examining **other ratios** that may be **relevant** to the particular **client's business**, such as revenue per passenger mile for an airline operator client, and fees per partner for a professional office.

5.2.2 Other techniques

Other analytical techniques include:

(a) **Simple comparisons**

A simple year on year comparison could provide very persuasive evidence that an expense such as rent is correctly stated, providing that the auditor has sufficient knowledge of the business, for example knowing that the same premises have been leased year on year and that there has been no rent review.

(b) Examining related accounts

Examining related accounts in conjunction with each other could provide evidence that a balance is fairly stated. Often revenue and expense accounts are related to asset and liability accounts and comparisons should be made to ensure relationships are reasonable.

(c) Reasonableness tests

These involve calculating the **expected value** of an item and comparing it with its actual value, for example, for straight-line depreciation.

(Cost + Additions – Disposals) × Depreciation % = Recognised in profit or loss This may

include the comparison of non-financial as well as financial information.

For example, in making an estimate of employee costs, probably for one specific department, such as manufacturing, the auditor might use information about the number of employees in the department, as well as rates of pay increases.

(d) Trend analysis

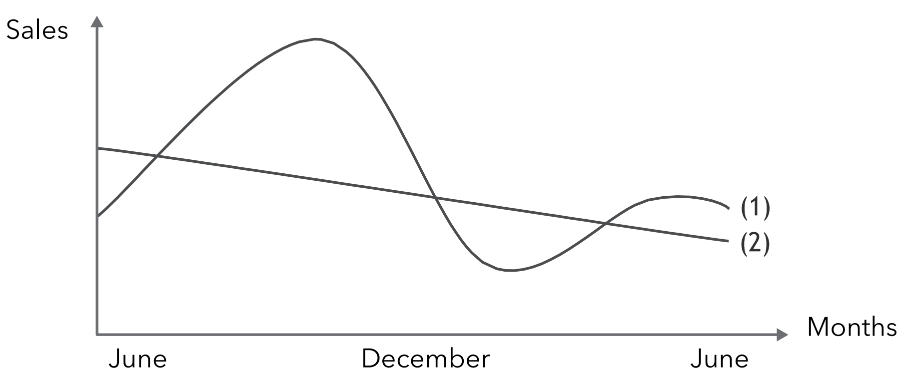
This is a sophisticated statistical technique that can be used to compare this period with the previous period. Information technology can be used in trend analysis, to enable auditors to see trends graphically with relative ease and speed.

Methods of trend analysis include the following:

- Scatter graphs
- Bar graphs
- Pie charts
- Any other visual representations
- Time series analysis
- Statistical regression

Time series analysis involves techniques such as eliminating seasonal fluctuations from sets of figures, so that underlying trends can be analysed. This is illustrated in the figure below.

Figure 6.1: Time series analysis



Line (1) in the diagram shows the actual sales made by a business. There is a clear seasonal fluctuation before Christmas. Line (2) shows a level of sales with 'expected seasonal fluctuations' having been stripped out.

In this analysis the seasonal fluctuations have been estimated. This analysis is useful, however, because the estimate is likely to be based on past performance, so the conclusion from this is that there might be a problem:

- Sales are below the levels of previous years.
- Sales are below expectation.

5.3 Analytical procedures as risk assessment procedures

ISA 315 (Revised) para.14 requires that risk assessment procedures include analytical procedures.

Analytical procedures are usually carried out at the **planning stage** of the audit because:

- it is a tool which assists in the **identification of risk**; and
- the result helps the auditor to **plan the audit approach**.

The benefits of adopting this technique are that:

- it helps to **focus** on the key priorities, as it is a 'top down' procedure; and
- it is an **efficient procedure**, due to its focus on key priorities.

5.3.1 Technique

Although ISA 520 deals with analytical procedures in the context of substantive procedures the same basic techniques would be applied when using analytical procedures as risk assessment procedures. The key stages in the process are as follows:

- **Interpretation**
- **Investigation**
- **Corroboration**

When potential problem areas have been identified, one of the key questions to ask is 'why?'.

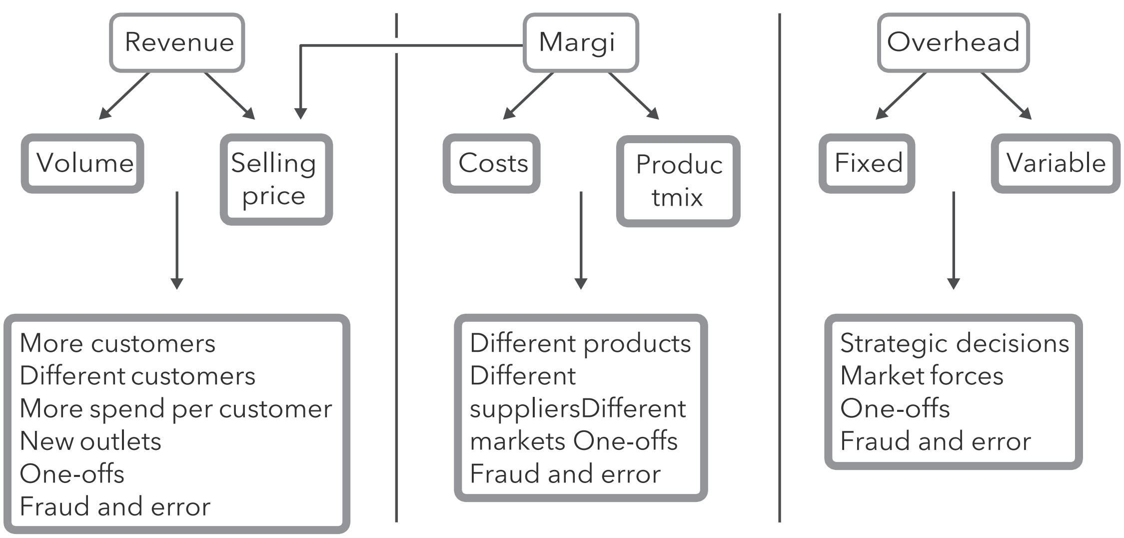
The statement of profit or loss and other comprehensive income

To apply this in more detail think about the client's statement of profit or loss and other comprehensive income.

The key question must be:

Why did the client make more (or less) money this year?

Figure 6.2: Statement of profit or loss



Changes in revenue must depend on changes in either:

- volumes; or
- prices.

Alternatively, it could be a combination of the two.

Changes in margins must have something to do with changes in:

- selling prices
- cost prices
- product mix

Changes in overheads will need to be identified line by line, but you might like to consider the different impacts of changes in:

- fixed overheads
- variable overheads

The boxes at the bottom of the diagram give some suggestions for the reasons why. The suggestions are not intended to be exhaustive, but they should give you a good basis for an answer to an analytical procedures type question.

A similar approach needs to be taken both to statement of financial position areas and those efficiency ratios which link statement of financial position figures to the performance ratios.

5.3.2 Financial and non-financial factors

ISA 520 stresses the need to consider the use of **non-financial information** eg, employee numbers and available selling space. Non-financial performance indicators can be found within the financial statements. In particular, an **operating and financial review**, or possibly the **chair's statement**, may serve as useful indicators as they attempt to comment on both the past and the future of the company. However, care must be taken in assessing the **reliability** of this information, as indicators may have been selected to ensure a positive message is conveyed.

Interactive question 5: Analytical procedures (1)

You are planning the audit of Darwin Ltd for the year ended 31 December 20X7. You are currently engaged in the interim audit during November 20X7. The company manufactures and distributes light fittings for both internal and external use. Approximately 40% of revenue is generated from overseas customers.

You have been provided with the following operating information.

	10 months to 31 Oct 20X7	10 months to 31 Oct 20X6	Year to 31 Dec 20X6
	£'000	£'000	£'000
Revenue	27,187	23,516	27,068
Cost of sales	16,040	14,966	17,175
Gross profit	11,147	8,550	9,893
Operating expenses	5,437	4,938	5,678
Operating profit	5,710	3,612	4,215
Gross profit margin	41%	36%	37%
Operating profit margin	21%	15%	16%
Inventories	5,160	4,320	4,080

Requirement

Based on the operating information identify and explain the potential audit risks.

See **Answer** at the end of this chapter.

Interactive question 6: Analytical procedures (2)

Libby Ltd is a ladies fashion retailer operating a chain of shops in the South-East of England from a head office in Guildford. Your firm has been the auditor of Libby Ltd for some years.

During the current year one shop was closed and the product range of the remaining eight shops was extended to include accessories and footwear.

The company has a computerised accounting system and the audit manager is keen to ensure that the audit is as efficient as possible.

As senior in charge of the audit you are currently planning the audit procedures for trade payables and you have obtained draft financial statements from the client.

Extracts from the draft financial statements:

	Year ended 31 March	
Statement of profit or loss and other comprehensive income	**Draft 20X7**	**Actual 20X6**
	£'000	**£'000**
Revenue	8,173	5,650
Gross profit	1,717	1,352

	As at 31 March	
Statement of financial position	**Draft 20X7**	**Actual 20X6**
	£'000	**£'000**
Non-current assets	2,799	2,616
Current assets	1,746	1,127
Trade payables	991	718
Other payables	514	460

Requirements

State what observations you can draw from the extracts from the draft financial statements and how they may affect your audit of trade payables.

6.1 Indicate how audit software could be used in the audit of trade payables to achieve a more efficient audit.

See **Answer** at the end of this chapter.

5.4 Analytical procedures as substantive procedures

5.4.1 Factors to consider

There are a number of factors which the auditors should consider when deciding whether to use analytical procedures as substantive procedures. You will have covered these in your Assurance studies. A brief reminder is given below.

Factors to consider	Example
The **suitability** of particular analytical procedures for given assertions	Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time, such as analysis involving revenue and gross profit margins.
The **reliability** of the data from which the auditors' expectations are developed	This will depend on factors such as: • the **source** of the information; and • the **comparability** of the data; industry comparison may be less meaningful if the entity sells specialised products.
The **detail** to which information can be **analysed**	Analytical procedures may be more effective when applied to financial information or individual sections of an operation such as individual factories and shops.
The **nature of information**	Financial: budgets or forecasts. Non-financial: eg, the number of units produced or sold.
The **relevance of the information** available	Whether the budgets are established as results to be expected rather than as tough targets (which may well not be achieved).
The **knowledge gained during previous audits**	The effectiveness of the accounting and internal controls. The types of problems giving rise to accounting adjustments in prior periods.

Factors which should also be considered when determining the reliance that the auditors should place on the results of substantive analytical procedures are:

Reliability factors	Example
Other audit procedures directed towards the same financial statements assertions	Other procedures auditors undertake in reviewing the collectability of receivables, such as the review of subsequent cash receipts, may confirm or dispel questions arising from the application of analytical procedures to a schedule of customers' accounts which lists for how long monies have been owed.
The **accuracy** with which the expected results of analytical procedures can be predicted	Auditors normally expect greater consistency in comparing the relationship of gross profit to sales from one period to another than in comparing expenditure which may or may not be made within a period, such as research and advertising.
The **frequency** with which a relationship is observed	A pattern repeated monthly as opposed to annually.

Reliance on the results of analytical procedures depends on the auditor's assessment of the **risk** that the procedures may mistakenly identify relationships (between data) when in fact there is a material misstatement (that is, the relationships do not in fact exist). It also depends on the results of investigations that auditors have made if substantive analytical procedures have highlighted significant fluctuations or unexpected relationships.

5.4.2 Substantive analytical procedures

In practical terms, the use of substantive analytical procedures involves four distinct steps:

(a) Firstly, **formulate expectations**

(b) Secondly, **compare expected value with the actual recorded amount**

(c) Thirdly, **obtain possible reasons for variance** between expected value and recorded amount

(d) Fourthly, **evaluate impact of any unresolved differences** between the expected and recorded amounts on the audit and financial statements

Each of these steps is explained below.

Formulate expectations

The auditor develops an expectation of figures in the financial statements using prior year financial statements, budgets, industry information etc. The expectation should be developed so that any material difference between this and the actual values in the financial statements indicates a potential misstatement. The auditor must also evaluate whether the expectation is sufficiently precise to identify a misstatement.

To carry out this procedure, the auditor will need access to industry data and environmental factors affecting that industry. Access to the financial statements is not required at this time, as this could prejudice the expectations of the auditor.

Example

The auditor is confirming the accuracy of salary expense in the statement of profit or loss and other comprehensive income.

The prior year salary figure can be obtained from the prior year financial statements. This year's salary can be estimated using the average number of employees (from personnel records) and the average salary again from personnel records. Changes in number of staff can be checked as reasonably accurate from knowledge of the industry sector (expanding or declining?) and initial knowledge of the client's business (expanding or contracting?). Average number of employees multiplied by average salary should give an approximate salary cost for the financial statements.

Compare expected value with the actual recorded amount

The auditor compares the expected value with the actual amount in the financial statements. In making this comparison, the auditor must decide the amount of deviation which will be allowed between the expected and actual figures – in other words, set a materiality limit. As assessed risk increases, the amount of difference considered acceptable without investigation decreases. If the difference between the two figures exceeds this materiality threshold then further investigation will be required in an attempt to explain the difference. If the difference is below the materiality threshold then no further investigation will be necessary.

The actual salary expense in the statement of profit or loss and other comprehensive income can be found. Assuming that salary cost does not involve overtime, then the estimated amount and the actual should be relatively close – materiality is likely to be set at, say, 10% difference between the two figures.

Obtain possible reasons for variances

The auditor attempts to identify reasons for the difference between the expected figure and the actual figure in the financial statements. The level of investigation depends to some extent on the accuracy of the auditor's expected figure. If the expected figure is precise, then more investigation will be expected. Conversely, if the expected figure has a larger element of imprecision, then it is less likely that any difference is due to misstatement and therefore less investigation work will be performed. (The auditor should have assessed whether expectations were capable of sufficiently precise measurement before adopting analytical procedures.)

Corroboration of any difference will normally start by obtaining written representations from management. However, these representations should be treated with scepticism due to the inherent problem of reliability of this source of evidence. Evidence from other sources will be required to ensure that written representations are accurate.

If the expected and actual salary expenses are more than 10% different, then further work is needed to determine why this is the case. Initial discussions with management may highlight areas where costs will be different eg, expansion in the last month of the year may skew the average number of managers to a larger number than expected. Or a salary increase late in the year may also inflate expectations of average salary. These written representations will be checked back in detail to the salary records.

Evaluate impact of any unresolved differences

Finally, the auditor will evaluate the impact of any unresolved differences on audit procedures and the financial statements. A large difference may mean that additional substantive procedures are required on the account balance to determine its accuracy. Any small remaining difference may be ignored as immaterial.

Hopefully, differences in expected and actual salaries will be resolved and any remaining residual difference will be immaterial. However, where differences remain, additional substantive testing of the salaries figure will be required.

5.5 Analytical procedures at the completion stage

ISA 520 states that analytical procedures performed when forming an overall conclusion are intended to corroborate conclusions formed during the audit. This assists the auditor in forming their opinion. The steps for carrying out analytical procedures at the completion stage of the audit may be very similar to those used as part of the risk assessment process at the planning stage. However, they are applied in a different way:

(a) Interpretation

The individual carrying out the analytical procedures reads through the financial statements and interprets them, considering the absolute figures themselves and the relevant ratios.

(b) Investigation

When analytical procedures are used as risk assessment procedures or as a substantive procedure the aim is to identify potential problems. The problems are then investigated during fieldwork by making inquiries and gathering audit evidence.

Considerations when carrying out such procedures may include the following:

(a) Whether the financial statements adequately reflect the information and explanations previously obtained and conclusions previously reached

(b) Whether the procedures reveal any new factors which may affect presentation or disclosures in the financial statements

(c) Whether the procedures produce results which are consistent with the auditor's knowledge of the entity's business

(d) The potential impact of uncorrected misstatements identified during the course of the audit

If analytical procedures identify a previously unrecognised risk of material misstatement, then the auditor should reassess risk and modify the audit plan and perform further procedures as required.

From a practical point of view it is worth remembering the following:

(a) For the smaller client, the working papers supporting the final analytical procedures may well be simply an update of the work done at the planning stage.

(b) For the larger client, the review becomes much more of a specific exercise.

(c) The financial statements used for the analytical procedures need to incorporate any adjustments made as a result of the audit.

5.6 Analytical procedures and other engagements

In this section we have been looking at the role of analytical procedures in the audit process. However, the skills and techniques involved may be applied to **other aspects** of the professional accountants' work.

Professional skills focus: Applying judgement

Judgement is always necessary when analytical procedures are used as part of your answer - what is the message behind the numbers and is any other information (either quantitative or qualitative) required?

Interactive question 7: Analytical procedures (3)

Harrison plc is a small jewellers based in Hatton Garden in London. Over the years it has built up an impressive client portfolio, and boasts names from high society as regular customers. You have recently joined the engagement team.

Harrison plc now needs to restructure its long-term and short-term financing in order to facilitate future growth, and has provided your firm with the following data to make an assessment of its liquidity. The firm is also looking to re-evaluate its performance measures and is seeking advice on what might be the most appropriate non-financial performance measures.

The following is an extract from the financial information provided by Harrison plc for the year ended 30 September 20X4.

	£m
Revenue	2.0
Purchases	1.2
Cost of sales	1.5
	£
Non-current assets	550,000
Inventory	300,000
Receivables	150,000
Cash	100,000
Payables	(100,000)
	1,000,000
Ordinary shares of 25p each	250,000
Reserves	350,000
7% preference shares of £1 each	250,000
15% unsecured loan stock	150,000
	1,000,000

The ordinary shares are currently quoted at 125p each, the loan stock is trading at £85 per £100 nominal, and the preference shares at 65p each.

Requirement

Evaluate the financial performance of the company. See **Answer** at the end of this chapter.

CHAPTER 6

6 Audit of accounting estimates

Section overview

- Accounting estimates and their disclosure require judgement and therefore lead to increased audit risk.

ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures* provides guidance on the audit of accounting estimates contained in financial statements and requires auditors to obtain sufficient, appropriate audit evidence regarding accounting estimates and how they are disclosed.

Definitions

Accounting estimate: A monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty.

Estimation uncertainty: Susceptibility to an inherent lack of precision in measurement.

The ISA gives the following examples of accounting estimates (ISA (UK) 540.A1):

- Allowance to reduce inventory due to obsolescence
- Depreciation methods
- Valuation or impairment of assets or financial instruments
- Provision for a loss from a lawsuit
- Revenue recognised for long term contracts
- Determination of fair value in a goodwill calculation

Directors and management are responsible for disclosing accounting estimates within the financial statements when something cannot be directly observed. The amount disclosed is usually referred to as **management's point estimate**.

Under ISA 540 (Revised) *Auditing Accounting Estimates and Related Disclosures* auditors are most concerned about **estimation uncertainty**, because the inherent limitations in any knowledge or data used to create accounting estimates inevitably lead to **increased risk of material misstatement** from either deliberate or accidental **management bias** in the financial statements. Auditors therefore need to consider **inherent risks** when assessing the estimation uncertainty attached to an accounting estimate. Other factors that the auditor should consider are the **complexity** and **subjectivity** involved in the creation of management's point estimate (ISA 540.2–3).

6.1 Audit procedures

Where estimation uncertainty, complexity and subjectivity exist, the auditor may need to exercise greater levels of **professional scepticism**. Professional scepticism should be maintained specifically for estimates relating to fair value, asset impairments and provisions.

Inherent risk factors that the auditor should consider include:

- the entity and its environment
- the experience that management has in developing its own point estimate
- the volatility associated with the estimate
- the degree of judgement and subjectivity involved when creating an estimate

As well as assessing inherent risk, auditors must also gain an understanding about **controls** related to accounting estimates, including sources of information and any supporting systems:

- that they exist and have been implemented
- that they are operating effectively

Audit procedures would be dependent on the results of this controls testing, although the ISA does point out that in some cases (such as high volumes of transactions or data processing) **substantive testing alone** may not be enough and **controls effectiveness** would still be required to determine sufficiency and appropriateness of audit evidence (ISA 540.A87–88).

When determining the **reasonableness** of accounting estimates and their disclosure, auditors may consider the following:

- how the estimate has been calculated, including the **method** used, its accuracy and any **assumptions** and **data** relied upon, in the context of the company's circumstances
- why that particular management's point estimate was **chosen**
- how the **estimation uncertainty** surrounding the estimate has been addressed by management and how this has been disclosed

Further audit procedures to address any concerns about estimation uncertainty may also include:

- obtaining evidence from events occurring up to the date of the auditor's report
- developing an auditor's point estimate or range

6.2 Evaluation of results of audit procedures

Where the auditor concludes that there is evidence of possible **management bias**, this should be treated in the same way as any other **fraud**. Otherwise, the outcome of audit procedures on accounting estimates should be considered in the context of the **auditor's report** (and in relation to any uncorrected factual, judgemental or projected misstatements in the context of ISA 450, covered further in Chapter 8).

6.3 Key audit matter

Where an accounting estimate has been identified as having a **high estimation uncertainty** the auditor may conclude that it is a key audit matter that requires disclosure in accordance with ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*. ISA 701 is also covered in Chapter 8.

7 Initial audit engagements – opening balances

Section overview

- Opening balances are those account balances which exist at the beginning of an accounting period.
- The auditor will perform audit procedures to ensure that those balances are accurately stated.
- Specific procedures may be required where the opening balances were not audited by the current audit firm.

7.1 Opening balances

Opening balances are those account balances which exist at the beginning of the period. Opening balances are based on the closing balances of the prior period and reflect the effects of:

- transactions and events of prior periods; and
- accounting policies applied to the prior period.

ISA 510, *Initial Audit Engagements – Opening Balances* provides guidance on opening balances:

- when the financial statements of an entity are audited **for the first time**; and
- when the financial statements for the prior period were audited by **a predecessor auditor**.

7.2 Requirements

The auditor shall obtain sufficient, appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

- determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, have been restated;
- determining whether the opening balances reflect the application of appropriate accounting policies; and
- performing one or more of the following:
  - Where the prior year financial statements were audited, reviewing the predecessor auditor's working papers to obtain evidence regarding the opening balances
  - Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances
  - Performing specific audit procedures to obtain evidence regarding the opening balances.

When the prior period's financial statements were audited by another auditor, the current auditor may be able to obtain sufficient, appropriate audit evidence regarding opening balances by reviewing the predecessor auditor's working papers., when the predecessor auditor ceases to hold office, if requested by the successor auditor, the predecessor auditor may allow the successor access to all relevant information in respect of its audit work. This includes access to relevant working papers.).

The nature and extent of audit procedures necessary to obtain sufficient, appropriate audit evidence on opening balances depends on matters such as the following.

- The accounting policies followed by the entity
- The nature of the account balances, classes of transactions and disclosures and the risks of material misstatement in the current period's financial statements
- The significance of the opening balances relative to the current period's financial statements
- Whether the prior period's financial statements were audited and, if so, whether the predecessor auditors' opinion was modified

If the auditor obtains audit evidence that the opening balances contain misstatements, that could materially affect the current period's financial statements, the auditor shall perform such additional audit procedures as are appropriate in the circumstances to determine the effect on the current period's financial statements.

7.2.1 Specific audit procedures

For current assets and liabilities some audit evidence may be obtained as part of the current period's audit procedures. For example, the collection (payment) of opening accounts receivable (accounts payable) during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period.

In the case of inventories, however, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period.

Therefore, additional procedures may be necessary, such as:

- observing a current physical inventory count and reconciling it back to the opening inventory quantities;
- performing audit procedures on the valuation of the opening inventory items; and
- performing audit procedures on gross profit and cut-off.

A combination of these procedures may provide sufficient, appropriate audit evidence.

For non-current assets and liabilities, some audit evidence may be obtained by examining the accounting records and other information underlying the opening balances. In certain cases, the auditor may be able to obtain some audit evidence regarding opening balances through confirmation with third parties, for example for long-term debt and investments. In other cases, the auditor may need to carry out additional audit procedures.

7.2.2 Consistency of accounting policies

The auditor shall obtain sufficient, appropriate audit evidence about whether the accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, and whether changes in the accounting policies have been appropriately properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

7.2.3 Prior period balances audited by a predecessor auditor

When the prior period's financial statements were audited by a predecessor auditor, the current auditor must read the most recent financial statements and predecessor auditor's report for information relevant to opening balances. The current auditor may be able to obtain sufficient, appropriate evidence regarding opening balances by performing this review depending on the professional competence and independence of the predecessor auditor. Relevant ethical and professional requirements guide the current auditor's communications with the predecessor auditor.

If there was a modification to the opinion, the auditor must evaluate the effect of the matter giving rise to the modification in assessing the risks of material misstatement in the current period's financial statements.

7.3 Audit conclusion and reporting

"If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements, as appropriate.

"If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not appropriately accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion, as appropriate." (ISA 510.10–11)

Note: The Appendix to the ISA gives illustrations of auditors' reports with modified opinions relating to opening balances. These have been updated to reflect the changes made to the equivalent IAASB ISA.

The auditor shall express a qualified opinion or an adverse opinion as appropriate if they conclude that:

- the current period's accounting policies are not consistently applied in relation to opening balances in accordance with the applicable financial reporting framework; or
- a change in accounting policies is not appropriately accounted for or not adequately presented or disclosed in accordance with the applicable financial reporting framework.

If the prior period auditor's report was modified, the auditor should consider the effect on the current period's financial statements. For example, if there was a scope limitation in the prior period, but the matter giving rise to the scope limitation has been resolved in the current period, the auditor may not need to modify the current period's audit opinion.

The ISA finishes:

"If the predecessor auditor's opinion regarding the prior period's financial statements included a modification to the auditor's opinion that remains relevant and material to the current period's financial statements, the auditor shall modify the auditor's opinion on the current period's financial statements." (ISA 510.13)

8 Using the work of others

Section overview

- In certain situations the auditor will consider it necessary to employ someone else with different expert knowledge to gain sufficient, appropriate audit evidence.
- If the auditor's client has an internal audit department, the auditor may seek to rely on its work.

8.1 Using the work of experts: revision

Professional audit staff are highly trained and educated, but their experience and training is limited to accountancy and audit matters. In **certain situations** it will therefore be necessary to employ someone else with **different expert knowledge** to gain sufficient, appropriate audit evidence. ISA 620 , *Using the Work of an Auditor's Expert* covers this area and the principles included in this standard were covered at Professional Level. The key points are covered below.

Definition

Auditor's expert: An individual or organisation possessing expertise in a field other than accounting and auditing, whose work in that field is used by the auditor in obtaining sufficient, appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (a partner or staff of the auditor's firm, or a network firm) or an auditor's external expert.

Note: The use of data analytics has increased the need for the use of IT experts in the audit team.

The ISA makes a distinction between this situation and the situation outlined in ISA 500, *Audit*

Evidence (see earlier in this chapter) where management use an expert to assist in preparing financial statements.

When using the work performed by an auditor's expert, auditors should obtain sufficient, appropriate audit evidence that such work is adequate for the purposes of an audit.

The following list of examples is given by the ISA of areas where it may be necessary to use the work of an auditor's expert:

- The valuation of complex financial instruments, land and buildings, plant and machinery, jewellery, works of art, antiques, intangible assets, assets acquired and liabilities assumed in business combinations and assets that may have been impaired
- The actuarial calculation of liabilities associated with insurance contracts or employee benefit plans
- The estimation of oil and gas reserves
- The valuation of environmental liabilities, and site clean-up costs
- The interpretation of contracts, laws and regulations
- The analysis of complex or unusual tax compliance issues

When considering whether to use the work of an expert, the auditors should review the following:

- Whether management has used a **management's expert** in preparing the financial statements
- The **nature and significance** of the matter, including its complexity
- The **risks of material misstatement**
- The auditor's knowledge of and experience with the work of experts in relation to such matters and the availability of **alternative sources of audit evidence**

8.1.1 Competence, capabilities and objectivity of the auditor's expert

When planning to use the work of an auditor's expert the auditors shall assess the professional competence (including professional qualifications, experience and resources) of the expert. The auditor shall evaluate the objectivity of the expert.

This will involve considering:

- the expert's **professional certification**, or licensing by, or membership of, an appropriate professional body and the technical performance standards and other requirements, such as ethical standards of that body;
- the **relevance** of the expert's competence to the matter for which that expert's work will be used, including any areas of speciality within that expert's field; and
- the expert's **competence** with respect to relevant **accounting and auditing requirements**, such as assumptions and methods required by the applicable financial reporting framework.

In considering the objectivity of the expert, the auditor should consider circumstances such as self- interest threats, advocacy threats, familiarity threat, self-review threats and intimidation threats as well as the safeguards that may have been put in place to eliminate or reduce these.

The auditor shall evaluate whether the auditor's expert has objectivity for the auditor's purposes. In the case of an auditor's external expert, the evaluation of objectivity shall include inquiry regarding interests and relationships that may create a threat to that expert's objectivity. (ISA 620.9)

Professional skills focus: Applying judgement

Remember that although an expert may be presented as the solution to your problem, they may also pose problems of their own if there are concerns about their competence, capability or objectivity, so you should be on the lookout for any evidence of this in an exam question.

8.1.2 Obtaining an understanding of the field of expertise of the auditor's expert

The auditor needs to have a sufficient understanding in order to be able to:

- determine the nature, scope and objectives of the expert's work for the auditor's purposes; and
- evaluate the adequacy of that work for the auditor's purposes.

8.1.3 Agreement with the auditor's expert

Written instructions usually cover the expert's terms of reference and such instructions may cover such matters as follows:

- The **nature**, **scope** and **objectives** of the expert's work
- The respective roles and responsibilities of the auditor and the expert
- The nature, timing and extent of communication between the auditor and the expert, including the form of any report to be provided by the expert
- The need for the expert to observe confidentiality requirements

8.1.4 Evaluating the adequacy of the auditor's expert's work

The auditors shall assess the adequacy of the expert's work for audit purposes.

Auditors should assess whether the substance of the expert's findings is properly reflected in the financial statements or supports the financial statement assertions. It will also require consideration of:

- the relevance and reasonableness of the expert's findings or conclusions, and their consistency with other audit evidence;
- the relevance and reasonableness of any significant assumptions and methods used; and
- the relevance, completeness and accuracy of any source data used.

The auditors do **not** have the expertise to judge the assumptions and methods used; this is the responsibility of the expert. However, the auditors should seek to obtain an understanding of these assumptions, to consider their reasonableness based on other audit evidence, knowledge of the business and so on.

If the results of the expert's work are not adequate for the auditor's purposes, the auditor shall:

- agree with the expert on the nature and extent of further work to be performed by the expert; or
- perform additional audit procedures appropriate to the circumstances.

8.1.5 Reference to the auditor's expert in the audit report

When issuing an unmodified audit opinion, the auditor should not refer to the work of the expert unless required by law or regulation to do so.

Such a reference may be misunderstood and interpreted as a qualification of the audit opinion or a division of responsibility, neither of which is appropriate.

If the auditors issue a modified audit opinion, then they may refer to the work of the expert if such a reference is relevant to an understanding of the modification. The auditor must also indicate in the report that the reference does not reduce the auditor's responsibility for the opinion. In such cases, auditors may need to obtain permission in advance from the expert. If such permission is not given, then the auditors may have to seek legal advice.

Interactive question 8: Using an expert – revision

Explain whether it is necessary to use the work of an auditor's expert in these situations. Where relevant, you should describe alternative procedures.

Requirements

8.1 As auditor to an oil exploration company, you have ascertained that the useful life of each drilling platform is assessed annually on factors such as weather conditions and the period over which it is estimated that oil will be extracted. You are auditing the useful lives of the platforms.

8.2 Piles of copper and brass, that can be distinguished with a simple acid test, have been mixed up. You are attending the inventory count.

See **Answer** at the end of this chapter.

8.2 Using the work of internal auditors

Using the work of internal auditors is covered at Professional Level in the Audit and Assurance paper. However, a summary of the key points of ISA 610, *Using the Work of Internal Auditors* is set out below.

8.2.1 Assessment of internal audit

First, the external auditors will determine whether and to what extent to use the work of internal auditors for the purposes of the audit by evaluating the following:

Evaluation of internal audit	
Objectivity	Consider the status of the function within the entity, who they report to, whether they have any conflicting responsibilities or restrictions placed on their function. Consider also to what extent management acts on internal audit recommendations.
Competence	Consider whether internal auditors have adequate resources, technical training and proficiency, and whether internal auditors possess the required knowledge of financial reporting. They will also consider whether the internal auditors are members of relevant **professional bodies.**
Systematic and disciplined approach	Consider whether internal audit is **properly planned**, **supervised**, **reviewed** and **documented**, whether the function has appropriate quality management procedures, audit manuals, work programmes and documentation.

8.2.2 The effect on external audit procedures

The external auditor then must determine the effect of the work of the internal auditors on the nature, timing or extent of the external auditor's procedures. The factors to consider are as follows:

- The **nature and scope** of the internal audit work

- The assessed **risks** of material misstatement
- The degree of **subjectivity** involved in the evaluation of the audit evidence

8.2.3 Evaluating specific internal auditing work

The ISA states: "The external auditor shall perform sufficient audit procedures on the body of the work of the internal audit function as a whole that the external auditor plans to use to determine its adequacy for the purposes of the audit." (ISA 610.23)

In practice, the evaluation here will consider the scope of work and related audit programmes and whether the original assessment of the internal audit function remains appropriate.

Evaluation	
Training and proficiency	Have the internal auditors had sufficient and adequate technical training to carry out the work? Are the internal auditors proficient?
Supervision	Is the work of assistants properly supervised, reviewed and documented?
Evidence	Has adequate audit evidence been obtained to afford a reasonable basis for the conclusions reached?
Conclusions	Are the conclusions reached appropriate, given the circumstances?
Reports	Are any reports produced by internal audit consistent with the result of the work performed?
Unusual matters	Have any unusual matters or exceptions arising and disclosed by internal audit been resolved properly?
Plan	Are any amendments to the external audit plan required as a result of the matters identified by internal audit?

The nature and extent of the testing of the specific work of internal auditing will depend on the amount of judgment involved.

The external auditor's procedures **must** include **reperformance of some of the work of the internal audit function**. If the external auditors decide that the internal audit work is not adequate, they should extend their own procedures in order to obtain appropriate evidence.

8.2.4 Direct assistance

In addition to using specific work done by an internal audit function, the external auditor may obtain direct assistance from individuals from the internal audit department. Where this is the case the external auditor:

- obtains written confirmation from those individuals and as an authorised member of the entity that they will follow instruction from the external audit team and that they will keep specific matters confidential;
- confirms with the head of internal audit or those charged with governance the role those individuals will play and the responsibility of the external auditor for quality management and the audit opinion;
- supervises, reviews and evaluates the work performed;
- ensures that such individuals are only involved in work where self-review or judgement is not an important part of the procedure; and
- agrees the approach with those charged with governance.

8.3 Service organisations

A service organisation is a third-party organisation that provides services to user entities that are part of those entities' information systems relevant to financial reporting.

ISA 402, *Audit Considerations Relating to an Entity Using a Service Organisation* provides guidance on how auditors carry out their responsibility to obtain sufficient, appropriate audit evidence when the audit client (called the 'user entity' in the standard) uses such an organisation. The use of service organisations will be discussed in detail in Chapter 7.

9 Working in an audit team

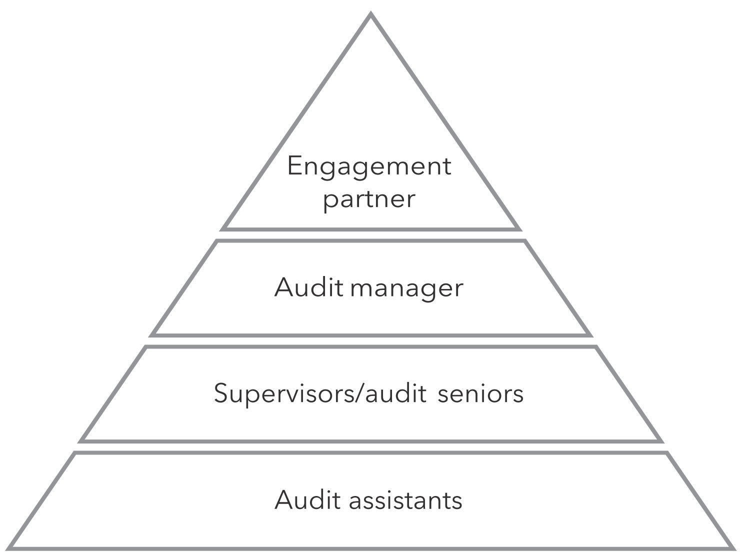
Section overview

- This section deals with working in an audit team.

The audit **engagement partner** (sometimes called the **reporting partner**) must take responsibility for the quality of the audit carried out. They should assign staff with necessary competences to the audit team.

Some audits are wholly carried out by a sole practitioner (an accountant who practises on their own) or a partner. More commonly, the engagement partner will delegate aspects of the audit work such as the detailed testing to the staff of the firm. The usual hierarchy of staff on an audit engagement is:

Figure 6.3: Audit staff hierarchy



9.1 Direction

The partner directs the audit. They are required by other auditing standards to hold a meeting with the audit team to discuss the audit, in particular the risks associated with the audit. ISA 220 para. A14 provides examples of direction techniques that the partner might use.

9.2 Supervision

The audit is supervised overall by the engagement partner, but more practical supervision is given within the audit team by senior staff to more junior staff (covered more fully by ISA 220 in para. A16).

9.3 Review

Before the auditor's report is issued, the engagement partner must be sure that sufficient and appropriate audit evidence has been obtained to support the audit opinion. The audit engagement partner need not review all audit documentation, but may do so. They must review critical areas of judgement, significant risks and other important matters (ISA 220.A17-21).

9.4 Consultation

Consultation is usually required to ensure difficult or contentious matters have been dealt with properly and that such matters and conclusions are properly recorded.

Professional skills focus: Concluding, recommending and communicating

As well as working together in a team where everyone understands their role and how they fit together, good audit quality can only be demonstrated by the way that the team formulates and communicates its findings.

10 Auditing in an IT environment

Section overview

- The more an organisation uses e-commerce, the greater the risk associated with it. As a consequence, there are special considerations for auditors performing the audit of companies who use e-commerce.

10.1 Introduction

We looked at IT-specific risks in the context of carrying out an audit risk assessment and the role of data analytics tools in this aspect of the audit in Chapter 5. Most companies now have a presence on the worldwide web: there are few companies who do not engage in some form of e-commerce nowadays.

E-commerce introduces specific risks. In this section, we will look at what this means for the auditor.

Definitions

Electronic data interchange (EDI): A form of computer to computer data transfer. Information can be transferred in electronic form, avoiding the need for the information to be re-inputted somewhere else.

Electronic mail (email): A system of communicating with other connected computers or via the internet in written form.

Electronic commerce (e-commerce): Involves individuals and companies carrying out business transactions without paper documents, using computer and telecommunications links.

10.2 Engaging in e-commerce

As e-commerce is a very fast-growing area of business, it is an important area for audit. For example, the trend is increasingly towards cloud-based services. The ICAEW Information Technology Faculty Helpsheet: *Standard terms for the provision of cloud computing services to clients* describes cloud computing as the "storage of data and software on remote computers, which are then used to deliver services over the internet to the users' preferred devices". This can be a particularly good option for smaller businesses to handle orders and process payments. There is no upfront investment and well- established providers offer services at competitive prices. Obvious advantages include the 'anywhere access', but issues of security and the stability of providers must be considered. Auditors must have an understanding of these kinds of developments and the impact that they will have on the business and the audit. The issues affecting the auditor's appraisal of systems including virtual arrangements and cloud computing are addressed in Chapter 7.

A business can engage in e-commerce to a large or small extent. The greater the involvement a business has with e-commerce, **the more the risk associated with it**. The extent of involvement is explored in the following table.

Involvement in e-commerce	Risk moving from:
Information provision. A website can be used as a marketing device, to provide information to potential customers, and to enable them to request further information through an email link.	**LOW**
Transactions with existing customers. Existing customers can be given the opportunity to track current contracts or initiate others over the website.	
Access to new customers. A website can be used as a place where new customers may initiate transactions with the company.	
New business model. A website can be used to diversify into specific web-based products, for example, data for download.	**HIGH**

There are a variety of business risks specific to a company involved in e-commerce, which will exist to a greater or lesser degree depending on the extent of involvement.

- Risk of non-compliance with taxation, legal and other regulatory issues
- Contractual issues arising: are legally binding agreements formed over the internet?
- Risk of technological failure (crashes) resulting in business interruption
- Impact of technology on going concern assumption, extent of risk of business failure
- Loss of transaction integrity, which may be compounded by the lack of sufficient audit trail
- Security risks, such as virus attacks and the risk of frauds by customers and employees
- Improper accounting policies in respect of capitalisation of costs such as website development costs, misunderstanding of complex contractual arrangements, title transfer risks, translation of foreign currency, allowances for warranties and returns, and revenue recognition issues
- Overreliance on e-commerce when placing significant business systems on the internet

Many of these issues have **implications for the statutory audit** and these are discussed in detail in the next section.

An entity that uses e-commerce must address the business risks arising as a result by implementing appropriate security infrastructure and related controls to ensure that the identity of customers and suppliers can be verified, the integrity of transactions can be ensured, agreement on terms of trade can be obtained, and payment from customers is obtained and privacy and information protection protocols are established.

In its paper *Across Jurisdictions in E-commerce,* the ICAEW IT Faculty states that an e-trader must ensure that it:

- displays and uses accurate information electronically;
- complies with relevant regulations and laws;
- intentionally trades only with specific geographical markets and customers;
- has contracts to facilitate effective transactions;
- monitors its contract process;
- keeps audit trails;
- creates and maintains appropriate levels of security; and
- takes appropriate insurance cover.

10.3 Considerations for auditors

With the withdrawal by IAASB of IAPS 1013, *Electronic Commerce – Effect on the Audit of Financial Statements,* there is currently no specific guidance on the special considerations for auditors who are undertaking audits of companies that use e-commerce. The logic is that, given the prevalence of e- commerce, this should no longer be viewed as a separate specialist audit area, but one to which the principles of any statutory audit should extend.

However, the following practical points are still relevant.

First, the auditor needs to consider whether the staff assigned to the audit have **appropriate IT and internet business knowledge** to carry out the audit. The auditor must also ensure that they have sufficient knowledge of the client's business in accordance with ISA 315 , *Identifying and Assessing the Risks of Material Misstatement*. In particular, the auditor must consider the following:

- The entity's business activities and industry
- The entity's e-commerce strategy
- The extent of the entity's e-commerce activities
- The entity's outsourcing arrangements

Internal controls can be used to mitigate many of the risks associated with e-commerce. The auditor has to consider the control environment, information and communication systems and control procedures in accordance with the requirements of ISA 315. There may be situations (such as the use of highly automated ecommerce systems, high transaction volumes, lack of electronic evidence) when the auditor would have to use tests of control as well as substantive procedures to render audit risk to an acceptably low level. In these situations, **CAATs** could be used. (Internal controls and CAATs will be covered in further detail in Chapter 7.)

When auditing an entity that uses e-commerce, the auditor must consider in particular the issues of security, transaction integrity and process alignment.

Cyber security

The auditor should consider the following:

- The use of **firewalls** and **virus protection software**
- The effective use of **encryption**
- Controls over the **development** and **implementation** of systems used to support e-commerce activities

- Whether **security controls** already in place remain effective as new technologies become available
- Whether the **control environment** supports the control procedures implemented

Transaction integrity

The auditor must consider the completeness, accuracy, timeliness and authorisation of the information provided for recording and processing in the financial records, by carrying out procedures to evaluate the reliability of the systems used for capturing and processing the information.

Process alignment

This is the way the IT systems used by the entity are integrated with one another to operate effectively as one system. Many websites are not automatically integrated with the internal systems of the entity, such as its accounting system and inventory management system, and this may affect such issues as the completeness and accuracy of transaction processing, the timing of recognition of sales, purchases and other transactions, and the identification and recording of disputed transactions.

11 Professional scepticism in the audit fieldwork stage

Section overview

We looked at professional scepticism in Chapter 5, in the context of audit planning. Professional scepticism is central throughout the audit process, and therefore must remain at the top of the agenda as the auditor gathers audit evidence and documents their work.

Ongoing global financial instability has increased the risk of misstatements. The risks centre particularly around judgemental areas where there may be no clear 'right answer', where the exercise of professional scepticism is more important than ever.

The areas of particular risk today include the following:

(a) **Fraud**: Consideration should be given to fraud at audit engagement team meetings. Fraud must be considered, regardless of how well the auditor knows the client.

(b) **Going concern**: Smaller entities often lack detailed management information (for example, profit forecasts), so the auditor needs to consider a broader range of audit evidence. The client's specific circumstances and the challenges the business faces must be documented, along with the conclusions reached.

(c) **Asset impairment**: The recent financial crisis has affected basic assumptions – for example, the expected future cash flows from long-term non-financial assets such as goodwill, plant and equipment and intangible assets. Where the audit client has non-financial assets located in, or related to, struggling economies, the value of such assets should be actively challenged. Where assets have been impaired, management's assumptions behind the impairment calculation also need to be scrutinised.

(d) **Valuation of receivables** and **revenue recognition**: Besides the likely impact of fraud on revenue recognition, the liquidity problems faced by companies and governmental organisations mean that bad debt allowances must be considered. Revenue should be recognised only when it is probable that future economic benefits will flow to the entity.

Worked example: Building professional scepticism into audit methodology

Audit firms are faced with the tricky task of building the exercise of professional scepticism into their audit methodology. How does one effectively instil a 'state of mind' into a standardised process consistently applied by hundreds upon thousands of individual staff members? Let's look at a real-life example.

One international audit firm does this, partly, by including instructions and reminders about exercising professional scepticism into its audit working paper templates. For example, the walkthrough of internal controls template includes the following instructions:

"Our inquiries during the walkthrough should include questions that could help to identify the abuse of controls or indicators of fraud. For example, our follow-up questions might include asking personnel what they do when they encounter errors, the types of errors they encounter, what happened as a result of finding errors, and how the errors were resolved. We might also ask the personnel whether they have ever been asked to override processes or controls, and to describe the situation, why it occurred, and what happened."

The working paper template also includes a checklist at the end, which audit staff are required to initial and date in order to indicate that they have addressed each of the requirements. An excerpt is reproduced below:

	Initials and date
We inquired of the Company personnel about their understanding of what was required by the Company's prescribed procedures and controls to determine whether the processing procedures are performed as originally intended and on a timely basis.	
We were alert to exceptions in the Company's procedures and controls.	
Our inquiries of Company personnel included follow-up questions that help to identify the abuse of controls or indicators of fraud.	

Requirement

Discuss the following with your peers:

(1) In what ways does this approach help to ensure professional scepticism is exercised in all audits?

(2) In what ways might the impact of this approach be limited?

(3) What other more effective methods can you think of to ensure that audit team members exercise professional scepticism when performing audit procedures?

Solution

The ICAEW Audit and Assurance Faculty released a video in 2011 on professional scepticism and other key audit issues (www.icaew.com/en/technical/audit-and-assurance/professional-scepticism).

The video usefully mentioned some questions which auditors should bear in mind as they perform audit fieldwork:

- Does the reporting reflect the substance of what has happened?
- Does it make sense?
- Are we focusing on the things that are there but missing the things that are not there – but should be?
- Are there limitations on the scope of our procedures?

- Are management's assumptions and forecasts appropriate?
- Are the assumptions still appropriate given the changing economy?
- What evidence is there besides what management has provided to us?
- Is the evidence contradictory?

In recent years, audit inspections have regularly pointed to the lack of scepticism in the performance of audits. Two key points emerge from these audit inspection reports:

- **Understanding the assumptions made is not enough**: Simply finding out what the client has done is not the same as auditing it. The auditor must challenge the assumptions and understand how they affect the client's conclusions.
- **The exercise of professional scepticism must be documented**: Often, judgements were made demonstrating appropriate scepticism – perhaps resulting from long conversations with the client – but only the conclusion is documented, with little evidence of the process.

The process of documenting audit evidence and counter-evidence in itself can often help to identify things that don't make sense.

The following example is adapted from the transcript of the ICAEW Audit and Assurance faculty's video on professional scepticism. It illustrates in a helpful way what is meant by documenting the exercise of professional scepticism.

Context example: Documenting professional scepticism

Ben is an audit senior. In the process of auditing the client's calculation for the impairment of accounts receivable, he identified that the discount rate used seemed out of line. He consulted Sophie, the audit manager, and she agreed that the discount rate appears inappropriate.

Ben then asked the client to explain how the discount rate had been calculated. In the course of the client's explanation, it became clear that the discount rate had been based on an incorrect assumption. After two hours of discussions, the client understood the error and agreed to revise the impairment calculation and adjust the financial statements accordingly.

Ben audited the revised impairment calculation and put it on the audit file. However, simply documenting the revised calculation would give no indication of the audit work that had been carried out earlier, nor would it show that professional scepticism had been exercised.

In order for the documentation to be complete, Ben should include a file note to explain the following:

- What issues were discussed with the client
- What the client said
- What evidence was offered
- What questions he then asked
- What further information was provided
- How he verified the information
- The final conclusion

11.1 Discussion among the engagement team

ISA 240 specifically requires the audit engagement team to have discussions around the susceptibility of the financial statements to fraud. Such a discussion should focus on how, and where, material misstatements due to fraud may occur.

Such discussions will facilitate:

- the sharing of insight by the more experienced members of the audit team into how to identify fraud risks;
- the consideration of an appropriate response to fraud risks, including determining who will conduct certain audit procedures; and
- the sharing of results from audit procedures with the rest of the audit team, and determining how any allegations of fraud that come to the auditor's attention will be dealt with.

It is the audit engagement partner's responsibility to decide which of the matters discussed are to be communicated to those team members who are not involved in the discussion.

11.2 Impact of use of audit data analytics

The use of audit data analytics provides both opportunities and threats to professional scepticism. It can be argued that the availability of data at a more granular level should provide the auditor with a better understanding of the entity and its environment enhancing the auditor's ability to apply professional scepticism. In addition the increased use of technology may reduce unintentional bias in audit procedures.

However care must be taken that confidence in the software is not absolute. Auditors must not believe that the results produced by data analytics tools are infallible. Professional judgement cannot be replaced by data analytics tools.

12 Further guidance

Section overview

This section covers a number of topics which have been dealt with in detail in your earlier studies. A brief reminder of the key points is provided below.

12.1 External confirmation

12.1.1 Introduction

You have covered the basic audit of receivables and cash and bank in your Assurance studies. This Appendix revisits this topic in the context of ISA 505, *External Confirmations*. The standard sets out guidance on how a confirmation should be carried out and, although it does not give a list of examples, the principles could be applied to confirmations such as:

- Bank balances and other information from bankers
- Accounts receivable balances
- Inventories held by third parties
- Property deeds held by lawyers
- Loans from lenders
- Accounts payable balances

High profile financial failures such as Barings and Parmalat in Europe heightened awareness of the use and reliability of external confirmations as audit evidence. Accordingly, some regulatory authorities in major jurisdictions around the world called for more rigorous requirements pertaining to the use of confirmations.

The major issue to be dealt with in the revision of this standard during the Clarity Project was to seek a solution that achieved a balance between the conflicting circumstances in which regulators and others have been demanding increasing prescription in the use of confirmations, and the anecdotal evidence from practitioners that responses to confirmation requests may be unreliable or unobtainable.

ISA 505 refers to the guidance on evidence from ISA 500, *Audit Evidence*, and the specific requirement, now in ISA 330, *The Auditor's Responses to Assessed Risks,* to consider, for each material class of transactions, account balance and disclosure, whether external confirmation procedures are to be performed as substantive procedures.

12.1.2 Requirements of ISA 505 Procedures

The auditor maintains control over the confirmation requests, including:

- determining the information to be requested;
- selecting the confirming party;
- designing the confirmation requests, including ensuring that they are correctly addressed and contain return information for replies to be sent directly to the auditor; and
- sending the requests (and second requests, if needed).

refusal

If management refuses to allow a confirmation request to be sent, the auditor shall do the following:

- Enquire as to the reason, and seek evidence as to their validity. (The risk here is that management may claim that the confirmation may cause problems in the context of disputes or litigation, but the auditor must remain sceptical and consider the possibility that this may be an attempt to deny access to evidence that might indicate the existence of fraud.)
- Evaluate the implications of refusal on the risk assessment.
- Perform alternative procedures.

Results

There is always a risk that responses may be intercepted, altered or be in some other way fraudulent. The auditor must be alert to any factors that suggest there is any doubt about the reliability of the responses, such as:

- it was received by the auditor indirectly (for example, was received by the client entity and passed on to the auditor); or
- it appeared not to come from the originally intended confirming party.

In the case of non-responses, the auditor must obtain alternative evidence, the form and nature of which will be affected by the account and the assertion in question.

Evaluating the evidence

The auditor must evaluate whether the confirmation results provide relevant and reliable audit evidence or whether further audit evidence is necessary.

12.1.3 Confirmation of accounts receivable Objectives of confirmation

ISA 505 is relevant to confirmation of accounts receivable. This section recaps the practical application of the standard. The verification of trade accounts receivable by direct communication is a normal means of providing audit evidence to satisfy the objective of checking whether customers exist and owe *bona fide* amounts to the company (**existence and rights and obligations**).

Confirmation will produce a written statement from each respondent that the amount owed at the date of the confirmation is correct. This is, *prima facie*, reliable audit evidence, being from an independent source and in 'documentary' form. The confirmation of accounts receivable on a test basis should not be regarded as replacing other normal audit checks, such as the in-depth testing of sales transactions, but the results may influence the scope of such tests.

Timing

Ideally the confirmation should take place immediately after the year end and hence cover the year end balances to be included in the statement of financial position. However, time constraints may make it impossible to achieve this ideal.

In these circumstances it may be acceptable to carry out the confirmation **before the year end** provided that confirmation is no more than three months before the yearend and internal controls are strong.

Client's mandate

Confirmation is essentially an act of the **client**, who alone can authorise third parties to divulge information to the auditors.

The ISA outlines what the auditors' response should be when management refuse permission for the auditors to contact third parties for evidence.

The auditor must:

- enquire as to management's reasons and seek supporting evidence;
- evaluate the implications on the auditor's assessment of the risks of material misstatement, including fraud;
- perform alternative audit procedures; and
- consider the implications for the audit opinion.

Positive vs negative confirmation

When confirmation is undertaken the method of requesting information from the customer may be either 'positive' or 'negative'.

- Under the **positive** method the customer is requested to confirm the accuracy of the balance shown or state in what respect they are in disagreement.
- Under the **negative** method the customer is requested to reply if the amount stated is disputed.

The positive method is generally preferable, as it is designed to encourage definite replies from those contacted.

The negative method may be used if the client has good internal control, with a large number of small accounts. In some circumstances, say where there is a small number of large accounts and a large number of small accounts, a combination of both methods, as noted above, may be appropriate.

Sample selection

Auditors will normally only contact a sample of receivables balances. If this sample is to yield a meaningful result it must be based on a complete list of all debtors. In addition, when constructing the sample, the following classes of account should receive special attention:

- Old unpaid accounts
- Accounts written off during the period under review
- Accounts with credit balances
- Accounts settled by round sum payments

Similarly, the following should not be overlooked.

- Accounts with nil balances
- Accounts which have been paid by the date of the examination:

Follow up procedures

Auditors must follow up customer disagreements and failure by customers to respond.

Auditors will have to carry out further work in relation to those debtors who:

- **disagree** with the **balance stated** (positive and negative confirmation); or
- **do not respond** (positive confirmation only).

In the case of disagreements, the customer response should have identified specific amounts which are disputed.

Reasons for disagreements
There is a **dispute** between the client and the customer. The reasons for the dispute would have to be identified, and provision made if appropriate against the debt.
Cut-off problems exist, because the client records the following year's sales in the current year or because goods returned by the customer in the current year are not recorded in the current year. Cut-off testing may have to be extended.
The customer may have sent the **monies before** the yearend, but the monies were **not recorded** by the client as receipts until **after** the yearend. Detailed cut-off work may be required on receipts.
Monies received may have been posted to the **wrong account** or a cash in transit account. Auditors should check if there is evidence of other mis-posting. If the monies have been posted to a cash in transit account, auditors should ensure this account has been cleared promptly.
Customers who are also suppliers may **net off balances** owed and owing. Auditors should check that this is allowed.
Teeming and lading, stealing monies and **incorrectly posting** other receipts so that no particular customer is seriously in debt is a fraud that can arise in this area. If auditors suspect teeming and lading has occurred, detailed testing will be required on cash receipts, particularly on prompt posting of cash receipts.

Additional procedures where confirmation is carried out before yearend

The auditors will need to carry out the following procedures where their confirmation is carried out before the yearend.

- Review and reconcile entries on the sales ledger control account for the intervening period.
- Verify sales entries from the control account by checking sales day book entries, copy sales invoices and despatch notes.
- Check that appropriate credit entries have been made for goods returned notes and other evidence of returns/allowances to the sales ledger control account.
- Select a sample from the cash received records and ensure that receipts have been credited to the control account.
- Review the list of balances at the confirmation date and year end and investigate any unexpected movements or lack of them (it may be prudent to send further confirmation requests at the year end to material debtors where review results are unsatisfactory).

CHAPTER 6

- Carry out analytical procedures, comparing receivables ratios at the confirmation date and yearend.

Evaluation and conclusions

All confirmations, regardless of timing, must be properly recorded and evaluated. All **balance disagreements** and **nonreplies** must be **followed up** and their effect on total receivables evaluated.

Differences arising that merely represent **invoices** or **cash in transit** (normal timing differences) generally do not require adjustment, but disputed amounts, and errors by the client, may indicate that further substantive work is necessary to determine whether material adjustments are required.

12.1.4 Bank reports for audit purposes Planning

The auditors should decide from which bank or banks to request confirmation, having regard to the risks in relation to relevant financial statement assertions including bank-related information to be disclosed in notes.

The auditor may be able to identify what banking relationships are in place by reviewing annual facilities letters from the entity's banks. If no such letters are available, the auditor will ask the entity's management to provide the information.

Given the importance of cash to an entity's business and its susceptibility to fraud, the auditor will usually conclude that in the absence of a bank report it will not be possible to obtain sufficient, appropriate audit evidence from other sources.

In planning the submission of the request, the auditor will:

- determine the date by which the bank report is needed;
- determine whether confirmation is needed of additional information, such as trade finance transactions and balances; and
- check that the bank has been given valid authority to disclose information to the auditor.

Preparation and despatch of requests and receipt of replies

Control over the content and despatch of confirmation requests is the responsibility of the auditors. However, banks require the explicit written authority of their customers to disclose information requested. Where possible this should take the form of an ongoing authority. Auditors need to satisfy themselves that an authority is in place and up to date. Replies should be returned directly to the auditors and, to facilitate such a reply, a pre-addressed envelope should be enclosed with the request.

Content of confirmation requests

The form and content of a confirmation request letter will depend on the purpose for which it is required and on local practices.

The most commonly requested information is in respect of balances due to or from the client entity on **current, deposit, loan and other accounts**. The request letter should provide the account description number and the type of currency for the account.

It may also be advisable to request information about **nil balances** on accounts, and accounts which were **closed** in the 12 months before the chosen confirmation date. The client entity may ask for confirmation not only of the balances on accounts but also, where it may be helpful, other information, such as the maturity and interest terms on loans and overdrafts, unused facilities, lines of credit/standby facilities, any offset or other rights or encumbrances, and details of any collateral given or received.

The client entity and its auditors are likely to request confirmation of **contingent liabilities**, such as those arising on guarantees, comfort letter, bills and so on.

Banks often hold **securities** and other items in safe custody on behalf of customers. A request letter may thus ask for confirmation of such items held by the bank.

The procedure is simple but important.

(a) The banks will require **explicit written authority** from their client to disclose the information requested.

(b) The **auditors' request** must **refer** to the **client's letter** of authority and the date thereof. Alternatively it may be countersigned by the client or it may be accompanied by a specific letter of authority.

(c) In the case of joint accounts, **letters of authority** signed by all **parties** will be necessary.

(d) Such **letters of authority** may either **give permission** to the bank to disclose information for a specific request or grant permission for an indeterminate length of time.

(e) Where practicable the request should **reach** the **bank** at least **one month in advance** of the client's **yearend. It is advisable to allow more time at busy periods, such as those covering December and March year ends. Fast track requests** may be made where reporting deadlines are tight. **The request** should state both the year-end date and the date of the authority to disclose.

(f) The **auditors** should themselves **check** that the bank response covers all the information in the standard and other responses.

12.2 Sampling

Definition

Audit sampling: Defined by ISA 530 *Audit Sampling* as:

"The application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population."

12.2.1 Nature of sampling

The audit involves a search for evidence, and sampling is, in part, a method of assessing the quantity and quality of that evidence. In so doing, an assessment needs to be made of an acceptable level of sampling risk ie, the risk that the sample will be unrepresentative of the population.

Sampling can be used to extract evidence for 'tests of details' or for 'tests of controls'. The stages of sampling involve the following:

(a) Sample design and selection

(b) Testing

(c) Evaluation

However, most research suggests that the proportion of evidence that is derived from sampling, particularly in respect of tests of details, has declined in recent years in favour of other sources of evidence. Typically, a small sample of items may be taken by many audit firms for tests of details, where there are no special circumstances – although the precise number of items tested tends to vary significantly.

12.2.2 Sample design

Is it necessary? – While auditing standards require some substantive testing, they do not require tests of detail, as analytical procedures alone may be sufficient in some circumstances.

Sample objectives – It is initially necessary to determine the purpose of the sample. This is likely to be different according to whether the sample is for tests of control or for tests of detail. Even in the latter case, objectives of assessing completeness, accuracy or validity will influence sample objectives.

Population – The selection of an appropriate population from which to sample is important. Consider the following.

- Is the population **homogeneous**? For example, if larger purchases are subject to more internal controls than smaller purchases, then all purchase transactions are not subject to the same risk and may need to be stratified into different samples.
- What is the level of risk expected in the population?
- If testing for understatement (completeness/omission) then it is important to sample from the population making up the initial record then tracing to the final record.
- If testing for overstatement (completeness/accuracy/validity) then it is important to select the sample from the population making up the final record then tracing to the initial record.
- **Directional testing** would not test all items for both over- and understatement. Populations which consist of debits would only be tested for overstatement and credits only tested for understatement. Given the duality of double entry, this means that any one transaction is tested for misstatement.

12.2.3 Types of sampling

ISA 530 permits either of the two basic methods of sampling:

- Statistical sampling
- Judgement sampling

All types of sampling require the exercise of judgement. However, judgement sampling is so called as the sample size and selection are based on the auditor's professional judgement rather than any statistical basis.

The advantages of statistical sampling include the following.

- It provides unbiased sample selection.
- Sample sizes can be based upon probability theory and can more easily be justified in court.
- It provides greater consistency of judgement between different auditors in similar circumstances.
- Evaluation of results can more validly be extrapolated into the population.

Disadvantages include the following.

- Excessive sample sizes can arise.
- Significant judgement in assessing the level of assurance required from sampling (relative to other evidence) is still needed, such that its statistical validity is questionable.

Statistical sampling is now less widely used than was once the case. Methods of sampling include the following.

Random sampling – Each item in the population has an equal chance of selection.

Systematic/Interval sampling – Takes a random start and selects every nth item thereafter (ie, at a constant interval). It is valid if errors are randomly distributed. The interval may be numerical (eg, order numbers) or by value – monetary unit sampling (ie, every nth £ of purchases).

Block/cluster sampling – The selection of a group of transactions occurring together (eg, a test of all sales in the month of June). This is unlikely to be representative of the population, which damages its statistical validity. It is, however, normally quicker to extract the data.

Haphazard selection – Items are selected without following a structured technique. Care must be taken with respect to sample selection bias and completeness of population. It may be appropriate where client records are poorly kept. Haphazard selection is not appropriate when using statistical sampling.

12.2.4 Sample size

Auditors need to acquire **sufficient** evidence and this means that determining sample size is important. Too few items incur undue sampling risk and too many items incur unnecessary costs.

Factors affecting sample size with respect to tests of detail include the following.

- Level of assurance required from sampling – If other sources of evidence are available and indicate low inherent and control risk then sampling may be reduced.
- Tolerable misstatement or tolerable deviation rate – When testing substantively, this is the maximum error the auditor is willing to accept in the sample – which is based on the performance materiality level, but could be set lower for a specific assertion. When tests of controls are being carried out, this is the number of deviations in the sample the auditor is willing to accept without changing the initial assessment of control risk.
- Expected misstatement or expected deviation rate – This is the expected level of error and deviation in the sample.
- Variability of the population – This is not relevant to sampling for tests of control but increased variability will increase sample sizes for substantive tests.
- The size of the population – Other than for very small populations, the size of the population has a minimal effect on sample sizes.

Appendix 2 and 3 to ISA 530 contain useful summaries of the factors influencing sample sizes.

12.2.5 Sample evaluation

For tests of details the auditor is required to project misstatements found.

The misstatements and deviations discovered in the sample need to be extrapolated into the population in order to draw conclusions about whether the population is materially misstated. (In order to do this appropriately it is important that the sample was representative of the population from which it was selected.) Where the estimated misstatement exceeds the tolerable misstatement then additional evidence may be needed.

Consider also the following.

- While management may adjust for misstatements actually discovered, consideration needs to be given to misstatements in unsampled items and whether any global adjustment is appropriate.
- There may be patterns or trends in the misstatements discovered.
- There may be a pattern from previous years, which would add additional insight into the extent of the misstatement in the population.
- Size and incidence of misstatements discovered eg, a few large misstatements or many small misstatements.
- Nature of the misstatements. Are they factual or are they perceived errors of judgement/opinion?
- Whether they are fraudulent.
- Whether a misstatement relates to the statement of financial position or to the statement of profit or loss and other comprehensive income.

For tests of controls an unexpectedly high sample deviation rate may lead to an increase in the assessed risk of material misstatement unless further audit evidence substantiating the initial assessment is obtained.

Note: Future improvements in technology and the use of audit data analytics may enable auditors to perform testing on 100% of a population, and to monitor transactions on a more frequent or even continuous basis(although currently the ability of data analytics to perform 100% testing is restricted to very limited types of information and audit assertions with respect to that information)

12.3 Directional testing

Directional testing is a method of discovering errors and omissions in financial statements.

Directional testing has been discussed in your previous auditing studies. It is a method of undertaking detailed substantive testing. Substantive testing seeks to discover errors and omissions, and the discovery of these will depend on the direction of the test.

Broadly speaking, substantive procedures can be said to fall into two categories:

- Tests to discover **errors** (resulting in over- or understatement)
- Tests to discover **omissions** (resulting in understatement)

12.3.1 Tests designed to discover errors

These tests will start with sampling the final **accounting records** in which the transactions are recorded and check from the entries to supporting documents or other evidence. Such tests should primarily detect any overstatement but also note any understatement through causes other than omission.

12.3.2 Tests designed to discover omissions

These tests must start from **outside the accounting records** and then check to those records. Understatements through omission will never be revealed if the auditor starts with the initial recording of a transaction (eg, an order form) and traces it through the various documents and accounts into the financial statements. There would clearly be no chance of selecting items that have been omitted if sampling was taken from the final accounts.

For most systems auditors would include tests designed to discover both errors and omissions. The type of test, and direction of the test, should be recognised before selecting the test sample. If the sample which tested the accuracy and validity of the sales ledger were chosen from a file of sales invoices then it would not necessarily substantiate the fact that there were no errors in the sales ledger. The approach known as 'directional testing' applies this testing discipline.

12.3.3 Directional testing and double entry

The concept of directional testing derives from the principle of double entry bookkeeping, in that for every **debit** there is a **corresponding credit** (assuming that the double entry is complete and that the accounting records balance). Therefore, any **misstatement** of a **debit entry** will result in either a corresponding **misstatement** of a **credit entry** or a **misstatement** in the opposite direction of **another debit entry**.

By designing audit tests carefully the auditors are able to use this principle in drawing audit conclusions, not only about the debit or credit entries that they have directly tested but also about the corresponding credit or debit entries that are necessary to balance the books. Tests are therefore designed in the following way.

Test item	Example
Test debit items (expenditure or assets) for overstatement by selecting debit entries recorded in the nominal ledger and checking value, existence and ownership	If a non-current asset entry in the nominal ledger of £1,000 is selected, it would be overstated if it should have been recorded at anything less than £1,000 or if the company did not own it, or indeed if it did not exist (eg, it had been sold or the amount of £1,000 in fact represented a revenue expense).
Test credit items (income or liabilities) for understatement by selecting items from appropriate sources independent of the nominal ledger and ensuring that they result in the correct nominal ledger entry	Select a goods despatched note and check that the resultant sale has been recorded in the nominal ledger sales account. Sales would be understated if the nominal ledger did not reflect the transaction at all (completeness) or reflected it at less than full value (say if goods valued at £1,000 were recorded in the sales account at £900, there would be an understatement of £100).

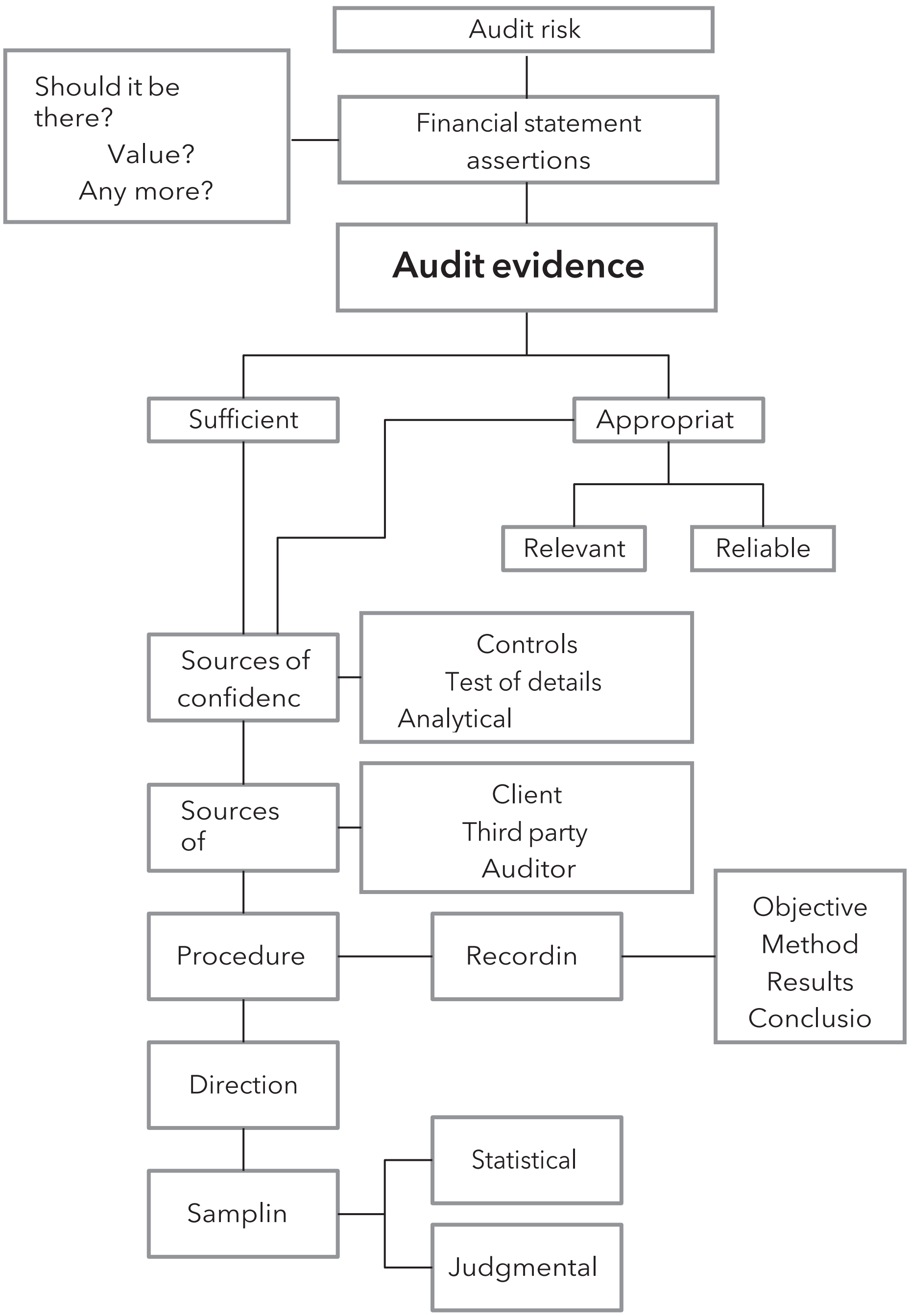
In a ledger account for (say) an asset, the balance would be a debit, but there may be both debit and credit entries in the account. In using directional testing on this asset account balance, the debit entries would be tested for overstatement and the credit entries for understatement. The reason is that the understatement of a credit entry would lead to the overstatement of the asset's debit balance on the account, the verification of which is the primary purpose of the test.

The matrix set out below demonstrates how directional testing is applied to give assurance on all account areas in the financial statements.

		Primary test also gives comfort on			
Type of account	**Purpose of primary test**	**Assets**	**Liabilities**	**Income**	**Expenses**
Assets	Overstatement (O)	U	O	O	U
Liabilities	Understatement (U)	U	O	O	U
Income	Understatement (U)	U	O	O	U
Expense	Overstatement (O)	U	O	O	U

A test for the overstatement of an asset simultaneously gives comfort on understatement of other assets, overstatement of liabilities, overstatement of income and understatement of expenses.

Summary


Audit risk
Should it be there?
Value?
Any more?
Financial statement assertions
Audit evidence
Sufficient
Appropriat
Relevant
Reliable
Sources of confidenc
Controls
Test of details
Analytical
Sources of
Client
Third party
Auditor
Procedure
Recordin
Objective
Method
Results
Conclusio
Direction
Samplin
Statistical
Judgmental

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Can you remember the assertions and how they help you to generate audit evidence?
2.	Are you able to explain what sufficient, appropriate audit evidence means and what you may need to do to make sure that you have it?
3.	Can you distinguish between tests of control, substantive analytical procedures and tests of detail?
4.	Do you know how to use the following audit procedures correctly: inquiry; observation; inspection; recalculation; reperformance; and external confirmation?
5.	Can you explain the various uses of analytical procedures throughout the audit and do you understand how different techniques can be used to generate audit evidence?
6.	Do you know what the terms 'estimation uncertainty' and 'management bias' mean in the context of the audit of accounting estimates?
7.	Can you explain how an initial audit engagement creates additional problems for auditors and describe the procedures that the auditor would use to address these problems?
8.	What are the problems of working both in a team and with others when conducting an audit? In the case of the latter, how will you evaluate the competence, capability and objectivity of others?
9.	Can you explain why the introduction of information technology adds extra risk to the audit and how auditors address these risks?
10.	Can you suggest areas of the audit where increased levels of professional scepticism may be particularly important?
11.	Can you explain how the auditor makes use of external confirmations, sampling techniques and directional testing during the audit?

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Strombolix plc	The scenario includes some fairly challenging situations that will require a combination of approaches to generate the necessary audit evidence. This will definitely help you to consider the evidence required in a given set of circumstances.

Question	Learning benefit from attempting this question
TrueBlue Ltd	Although this is quite a short scenario, there is still plenty of opportunity to deploy your analytical procedures and professional scepticism skills.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios that will help you improve your knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Maykem	You will need to identify potential shortcomings in best practice by evaluating the audit procedures that have been completed by the audit assistant. This will therefore help you learn what good audit procedures should look like.
Dormro	An integrated scenario question that requires the identification of additional audit procedures necessary to form an opinion on the group financial statements.
Tydaway	An opportunity to practise writing suitable audit procedures for the audit of a specific part of the financial statements, in this case, inventory.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving on to the next chapter.

Technical reference

1 **ISA 210**

- Terms of audit engagements – **ISA 210.9-12**

2 **ISA 402**

- Definition – **ISA 402.8**
- Understanding the entity – **ISA 402.9–.14**
- Audit procedures for obtaining audit evidence – **ISA 402.15–.16**
- Reference in audit reports – **ISA 402.20–.22**

3 **ISA 315**

- List of audit assertions – **ISA 315.A190**

4 **ISA 500**

- Sufficient and appropriate audit evidence – **ISA 500.A1–.A6**
- Audit procedures for obtaining audit evidence – **ISA 500.A10–.A25**
- Evidence from information produced by a management's expert – **ISA 500.A34–.A48**

5 **ISA 501**

- Procedures regarding litigation and claims – **ISA 501.9–.12, .A17–.A25**

6 **ISA 505**

- Considerations in obtaining external confirmation evidence – **ISA 505.2–.3**
- External confirmation procedures – **ISA 505.7–.16**

7 **ISA 510**

- Need to obtain audit evidence – **ISA 510.3**
- Audit procedures – **ISA 510.5–.9**
- Audit conclusions and reporting –**ISA 510.10–.13**

8 **ISA 520**

- Definition – **ISA 520.4**
- Use of analytical procedures as substantive procedures – **ISA 520.5, A4–.A16**
- Analytical procedures when forming an overall conclusion – **ISA520.6, A17–A19**

9 **ISA 530**

- Definitions – **ISA 530.5**
- Design of the sample – **ISA 530.A4–.A9**
- Sample size – **ISA 530.A10–.A13, Appendix 2**
- Evaluation of sample results – **ISA 530.A21–.A23**

10 ISA 540

- Examples of accounting estimates – **ISA 540.A1**
- Risk assessment procedures – **ISA 540.13–15**
- Responses to assessed risks of material misstatement – **ISA 540.18–30**
- Evaluation of results of audit procedures – **ISA 540.33–36**

11 ISA 550

- Definitions – **ISA 550.10**
- Risk assessment procedures – **ISA 550.11–17**
- Audit procedures – **ISA 550.20–.24**
- Written representations and reporting – **ISA 550.26–.27**

12 ISA 610

- Evaluating the internal audit function – **ISA 610.15–.16**
- Using the work of internal audit – **ISA 610.21–.25**

13 ISA 620

- Definition – **ISA 620.6**
- Determining the need to use the work of an auditor's expert – **ISA 620.7**
- Competence, capabilities and objectivity of the auditor's expert – **ISA 620.9, A14–A20**
- Agreeing the scope of the auditor's expert's work – **ISA 620.11**
- Evaluating the work of the auditor's expert – **ISA 620.12–.13**
- Reference in audit report – **ISA 620.14–.15**
- Documentation – **ISA 620.15–1**

Self-test questions

Answer the following questions.

1 Strombolix plc

Strombolix plc (Strombolix) is a listed company which manufactures and retails paints and other decorating products. You are the senior in charge of the audit of Strombolix for the year ending 30 June 20X2, which is currently in progress.

Background information provided

The company owns a large factory manufacturing paints. These paints are sold retail through Strombolix's six superstores and they are also sold wholesale to other DIY retailers. In addition, the six superstores sell a range of other products from different suppliers. The superstores are each separate divisions, but there are no subsidiaries.

On 23 July 20X2 a bid was announced by Simban plc (Simban) to acquire the entire ordinary share capital of Strombolix. The directors of Strombolix are contesting the bid and are anxious to publish the financial statements to indicate that the company is more profitable than indicated by the Simban offer.

As a result of the bid your audit partner has sent you the following memorandum.

To: A Senior

From: Charles Church (partner)

Date: 24 July 20X2

Subject: Strombolix audit

As you will be aware, Simban made a bid for Strombolix yesterday and this increases the significance of the financial statements that we are currently auditing.

I am having a preliminary meeting with the finance director on 1 August to discuss the conduct of the audit. I would like you to prepare notes for me of any audit and financial reporting issues that have arisen in your work to date that may indicate potential problems. Also include any general audit concerns you may have arising from the takeover bid.

Let me know what you intend to do about these matters and specify any questions that you would like me to raise with the finance director.

Further information

The following issues have been reported to you from junior audit staff during the audit to date.

AUDIT ISSUES

(1) There appears to be a significant increase in trade receivables, due to the fact that many wholesale customers are refusing to pay a total of £50,000 for recent deliveries of a new paint that appears to decay after only a few months of use. Some of the wholesale customers are being sued by their own customers for both the cost of the paint and the related labour costs. No recognition of these events has been made in the draft financial statements.

(2) A special retail offer of '3 for 2' on wallpaper purchased from an outside supplier during the year has been incorrectly recorded, as the offer was not programmed into the

company's IT system. The sales assistants were therefore instructed by store managers to read the bar codes of only two of the three items, and ignore the third 'free' item. The wallpaper sells for £6 per roll and cost £5 per roll from the supplier. A total of 20,000 of these rolls were processed through the IT system by sales assistants during the year.

The reason for the special offer was that a bonus payment of £90,000 will be due to Strombolix from the supplier if 40,000 of these rolls of wallpaper are sold by 31 December 20X2. Strombolix has taken 50% of this amount (ie, £45,000) into its draft statement of profit or loss and other comprehensive income as revenue for the year to 30 June 20X2.

(3) One of the six superstores was opened on 30 May 20X2. The land had been purchased at a cost of £400,000 on 1 August 20X1, but it was only on 1 September 20X1 that the company began to prepare an application for planning permission. This was granted and construction commenced immediately thereafter, being paid for in two progress payments of £1 million each on 1 December 20X1 and on 1 June 20X2. Construction was completed, and the store opened, on 30 May 20X2. All the costs were financed by borrowing at 8% per annum and all the interest incurred up to 30 June 20X2 has been capitalised as part of the cost of the non- current asset in the draft financial statements. There was no interest earned on surplus funds from this loan.

Requirement

Draft the notes required by Charles Church's memorandum.

2 AB Milton Ltd

You are the senior in charge of the audit of AB Milton Ltd for the year ended 31 May 20X1. Details of AB Milton Ltd and certain other companies are given below.

AB Milton Ltd

A building company formed by Alexander Milton and his brother, Brian.

AB Milton Ltd has issued share capital of 500 ordinary £1 shares, owned as shown below.

Alexander Milton	210	42%	Founder and director
Brian Milton	110	22%	Founder and director
Catherine Milton (Brian's wife)	100	20%	Company secretary
Diane Hardy	20	4%	
Edward Murray	60	12%	Director

Edward Murray is a local businessman and a close friend of both Alexander and Brian Milton. He gave the brothers advice when they set up the company and remains involved through his position on the board of directors. His own company, Murray Design Ltd, supplies AB Milton Ltd with stationery and publicity materials.

Diane Hardy is Alexander Milton's ex-wife. She was given her shares as part of the divorce settlement and has no active involvement in the management of the company. Alexander's girlfriend, Fiona Dyson, is the company's solicitor. She is responsible for drawing up and reviewing all key building and other contracts, and frequently attends board meetings so that she can explain the terms of a particular contract to the directors. Her personal involvement with Alexander started in May 20X1 and, since that time, she has spent increasing amounts of time at the company's premises.

Cuts and Curls Ltd

A poodle parlour, of which 50% of the issued shares are owned by Diane Hardy and 50% by Gillian Milton, who is Alexander and Diane's daughter.

Cuts and Curls operates from premises owned by AB Milton Ltd for which it pays rent at the normal market rate.

Campbell Milton Roofing Ltd

A roofing company owned 60% by AB Milton Ltd and 40% by Ian Campbell, the managing director.

Campbell Milton Roofing Ltd carries out regular work for AB Milton Ltd and also does roofing work for local customers. Alexander Milton is a director of Campbell Milton Roofing Ltd and Catherine Milton is the company secretary. All legal work is performed by Fiona Dyson.

Requirements

2.1 Based on the information given above, identify the potential related party transactions you expect to encounter during the audit of AB Milton Ltd and summarise, giving your reasons, what disclosure, if any, will be required in the full statutory accounts.

2.2 Prepare notes for a training session for junior staff on how to identify related party transactions. Your notes should include the following:

(a) A list of possible features which could lead you to investigate a particular transaction to determine whether it is in fact a related party transaction

(b) A summary of the general audit procedures you would perform to ensure that all material related party transactions have been identified

CHAPTER 6

3 TrueBlue Ltd

You are planning the audit of TrueBlue Ltd, a company that has experienced a downturn in trading over recent years. The finance director has provided you with the following information for you to review before a planning meeting with him.

Statement of profit or loss and other comprehensive income extracts

	20X7	20X6	20X5
	£	£	£
Revenue	18,944,487	20,588,370	24,536,570
Cost of sales	14,587,254	14,413,543	17,176,922
Gross profit	4,357,233	6,174,827	7,359,648
Advertising and marketing	554,288	206,688	207,377
Legal costs	14,888	2,889	34,668
Electricity	199,488	204,844	206,488
Travel costs	65,833	30,892	53,588
Audit fee	21,000	21,000	20,488

Statement of financial position extracts

	20X7	20X6	20X5
	£	£	£
Trade receivables	3,477,481	3,553,609	4,089,783
Trade payables	1,056,090	1,027,380	1,164,843

Cost of sales analysis

	20X7	20X6	20X5
	£	£	£
Purchases	9,183,388	9,246,420	10,483,588
Other direct costs	6,419,410	6,894,300	7,087,148
Inventory movement	(1,015,544)	(1,727,177)	(393,814)

Requirements

3.1 Outline the areas of the financial statements you would discuss with the finance director at your planning meeting as a result of the analytical procedures that you perform on these figures, giving your reasons and also set out any further information you would request.

3.2 Explain whether your approach would be different if you had received a tip off that the finance director has been carrying out a fraud on receipts from receivables and, if it would be different, outline how it would be different.

3.3 Describe how you approach the audit of receivables as a result of the tip off about the finance director.

4 Tofalco plc

You are an audit senior in the process of carrying out the final audit for the year ended 30 September 20X0 for Tofalco plc, a construction company with business activities across the UK and Ireland.

The following message is left on your answer machine by Paul Sykes, Head of Audit. "Good morning Jeremy,
Paul Sykes here. Hope all is well with you.

I have left a memo in your mailbox with the items outstanding on the year-end audit of our client Tofalco plc.

Please prepare a memo showing the appropriate financial reporting treatment for each item in the financial statements for the year ended 30 September 20X0 and the audit procedures required to gain assurance in each area.

I am concerned as the directors appear to be unwilling to provide full details of their related parties' remuneration and seem to be denying access to the company board minutes. They are also refusing to recognise the obligations required under IAS 37 with respect to environmental costs. Please give me your opinion on the effects of these non-compliance issues on audit risk and on the form of the audit report to be issued.

Tofalco plc have also asked that we advise them on the way they should work with Investo Ltd, a company to which they plan to outsource their investment activities. Tofalco plc wishes to agree on terms of co-operation that minimise risks of financial loss, fraud and error. Is there any impact on our audit going forward?

Finally, can you prepare a list of the ethical issues you foresee on this assignment. They would be helpful to have to hand.

Call me if you have any queries."

To: Jeremy Wiquad

From: Paul Sykes

Date: 5 November 20X0

Subject: Year-end audit of Tofalco plc – Outstanding points

Construction contracts

Tofalco plc's largest current project is the construction of a water pipeline under the Mediterranean Sea. The project commenced late in 20W9 and completion is not expected until 20X6.

By 30 September 20X0, the following figures apply.

	£m
Sales value of contract	8,500
Costs incurred to date	400
Estimated future costs	7,000
Sales value of work completed to date	560

The directors do not yet believe that the project is sufficiently far advanced for the outcome to be assessed with any degree of certainty. The company's accounting policy is to take attributable profit on the basis of the sales value of the work completed.

Environmental and other provisions

Tofalco plc has a number of long-term obligations arising from the local laws on the environment. Tofalco is obligated to dispose of its scrap machinery in a particular way which minimises the damaging effect on the environment.

The machinery held by Tofalco at the year end has a total carrying amount of £25 million and it is estimated that the present value of the cost to dispose of these machines will be some £2.5 million.

One of Tofalco's biggest customers, Stirly plc, is refusing to pay a sum of £4 million. No provision has been created by the company and the reasons are unclear as to why Stirly plc is holding back payment, with management being vague in their explanations and appearing to be denying access to the company board minutes.

Assets held for sale

On 1 January 20X0, Tofalco plc committed to selling an owner-occupied building which had a carrying amount of £2.16 million at that date. The building was available for immediate sale from that date but the company continued to occupy and use the building until 1 February when the carrying amount was approximately £2.1 million. The recoverable amount is estimated at £1.7 million. The building has yet to be sold by 30 September 20X0.

Issue of convertible loan stock

On 1 March 20X0, Tofalco plc issued £18 million of convertible loan stock, which is either redeemable in three years' time for £20 million, or convertible into 500,000 ordinary £1 shares.

The present values of the cash flows, discounted at the interest rate on a debt instrument with similar terms except that there is no conversion option, are as follows.

	£
Present value of principal	15,902,000
Present value of interest	960,000
	16,862,000

Related parties

Tofalco plc purchases significant quantities of raw materials from Sandstone Ltd, a company whose Finance Director is also a shareholder in Tofalco plc. During the year ended 30 September 20X0 alone, Tofalco plc purchased £230 million worth of raw material from Sandstone Ltd with a credit payment period of three months. The normal credit period provided within the industry is two months.

Requirement

Respond to Paul Sykes's request.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

Audit area	Key question	Examples of procedures	Assertions
Non-current assets	Should it be in the accounts at all?	Physically verify Inspect title deeds/invoice/vehicle registration documents Board minutes and other authority thresholds	Existence Rights and obligations
	Is it included at the right amount?	Inspect invoices/contracts Check depreciation	Accuracy, valuation and allocation
	Are there any more?	Review other accounts for items which should be capitalised Check assets physically verified are included in the financial statements	Completeness
	Is it properly disclosed and presented?	Companies Act checklist	Classification Presentation
Receivables	Should it be in the accounts at all?	Circularisation After date cash Inspect invoices	Existence Rights and obligations
	Is it included at the right amount?	Inspect ageing analysis After date cash	Accuracy, valuation and allocation
	Are there any more?	Conclusion derived from sales completeness testing Cut-off work	Completeness
	Is it properly disclosed and presented?	Companies Act checklist	Classification Presentation
Payables	Should it be in the accounts at all?	Suppliers' statement reconciliation Conclusion derived from purchases testing	Existence Rights and obligations
Payables	Is it included at the right amount?	Suppliers' statement reconciliation	Accuracy, valuation and allocation
	Are there any more?	Unpaid invoices review Review payments after year end to check for omitted liabilities Cut-off work Review for obvious omissions of accruals Review payables at last year end to check for omissions this year	Completeness

Audit area	Key question	Examples of procedures	Assertions
		Review knowledge of major suppliers to check for omissions	
	Is it properly disclosed and presented?	Companies Act checklist	Classification Presentation
Inventory	Should it be in the accounts at all?	Attend inventory check – test from records to test counts Cut-off work Consider inventory held for third parties or on consignment	Existence Rights and obligations
	Is it included at the right amount?	Inspect invoices and other costing evidence Review for slow-moving or obsolete items Evidence of slow-moving or damaged items from inventory check	Accuracy, valuation and allocation
	Are there any more?	Attend inventory check – test from test counts to records Cut-off work Consider other locations, inventory held by third parties on consignment	Completeness
	Is it properly disclosed and presented?	Companies Act checklist	Classification Presentation

Answer to Interactive question 2

2.1 The relevant financial statement assertions would be as follows.

- **Completeness**

  There is a risk that all share-based payments may not have been recognised in the financial statements, as the provision of the benefit to the employee may not arise until some point in the future. For example, in this case the options cannot be exercised until the directors have been with the company for three years. In accordance with IFRS 2 the service acquired in a share- based payment should be recognised as received.

- **Accuracy**

  The remuneration expense should reflect the fact that the service received in exchange for the share-based payment will be received over a period of time ie, three years (see calculation below). It also needs to be estimated how many of the five directors will remain with the company and hence how many of the options are likely to vest.

- **Accuracy, valuation and allocation**

  Equity should be increased by the fair value of the options at the grant date (see calculation below).

  Remuneration expense this year and equity recognised in respect of the options will be: (5 × 100,000) × £3/3 years × 4/12 = £166,667

2.2 The relevant financial statement assertions relate to disclosure as follows.

- **Classification**

  Whether the transaction is a related party transaction. 40% would appear to indicate the ability of Wiggam plc to exert significant influence assuming no other entity has control.

- **Completeness**

  Whether there are any other related party transactions between these two parties and/or whether there are any additional related party relationships.

- **Accuracy**

  If the disclosure states that the transaction is on an arm's length basis this must be substantiated.

2.3 The relevant financial statement assertions are:

- **Classification**

  Whether a bond should be classified as debt or equity. In this case it is a compound instrument. The liability and equity component will be shown separately.

- **Accuracy, valuation and allocation**

  The liability component should be computed as the present value of the maximum potential cash flows discounted @ 10% as follows.

Year	**Cash flow**	**DF @ 10%**	**Net present value**
	£		**£**
1	6,000	0.909	5,454
2	106,000	0.826	87,556
Liability			93,010

The residual amount is the equity component (100,000 – 93,010) = £6,990.

Answer to Interactive question 3

3.1 Appropriate – relevance

The relevance of audit evidence should be considered in relation to the overall audit objective of forming an opinion and reporting on the financial statements. The evidence should allow the auditor to conclude on the following:

- Statement of financial position items (existence, rights and obligations, completeness, accuracy, valuation and allocation, classification and presentation)
- Statement of profit or loss items (occurrence, completeness, accuracy, cut-off, classification and presentation)

The representations by management in respect of the completeness of sales are relevant to the first of the objectives when gathering evidence on revenue items. Depending on the system operated by the client and the controls over cash sales there may be no other evidence as to the completeness of sales.

Appropriate – reliable

Reliability of audit evidence depends on the particular circumstances but the standard offers three general presumptions:

- Documentary evidence is more reliable than oral evidence.
- Evidence obtained from independent sources outside the entity is more reliable than that secured solely from within the entity.

- Evidence originated by the auditor by such means as analysis and physical inspection is more reliable than evidence obtained by others.

The oral representations by management would be regarded as relatively unreliable using the criteria in the standard, as they are oral and internal. In the absence of any external or auditor-generated evidence, the auditor should ensure that these representations are included in the letter of representation so that there is at least some documentary evidence to support any conclusions.

Sufficiency

The auditor needs to obtain sufficient relevant and reliable evidence to form a reasonable basis for their opinion on the financial statements. Their judgements will be influenced by such factors as:

- their knowledge of the business and its environment;
- the risk of misstatement; and
- the persuasiveness of the evidence.

3.2 Appropriate – relevance

The flowcharts prepared by the internal audit department will not be directly relevant to the auditor's opinion on individual figures in the financial statements, but rather when the auditor is following the requirement in ISA 315 to obtain an understanding of the entity's information system of recording and processing transactions. The auditor will wish to assess the adequacy of the system as a basis for the preparation of financial statements so the flowcharts will be relevant only if they are sufficiently detailed to allow the auditor to carry out this assessment.

The auditor would also wish to make an initial assessment of internal controls at this stage so the flowcharts will be more relevant if control procedures are specifically identified.

Appropriate – reliable

The assessment of how reliable the flowcharts are would depend on the auditor's overall assessment of the internal audit department. The factors to be considered would include its degree of independence, the scope of its work, whether due professional care had been exercised, the technical competence and the level of resource available to the internal audit department. This assessment should be documented by the external auditor if they are to make use of the flowcharts in their audit planning and design of tests.

Sufficiency

Client-prepared flowcharts are **not** sufficient as a basis for the auditor's evaluation of the system. To confirm that the system does operate in the manner described, the auditor should perform 'walkthrough' checks, tracing a small number of transactions through the system. There is, however, no need for the auditor to prepare their own flowcharts if they are satisfied that those produced by internal audit are accurate.

3.3 Appropriate – relevance

Year-end suppliers' statements provide evidence relevant to the auditor's conclusions on:

- the completeness of payables, as omissions from the purchase ledger listing would be identified by comparing statements received to that listing;
- the existence of payables recorded in the purchase ledger;
- the fact that the liabilities are properly those of the entity (for example, the statements are not addressed to, say, the managing director in his own name); and
- the valuation of payables at the year end with respect to cut-off of invoices and credit notes, and discounts or allowances.

Appropriate – reliable

Suppliers' statements would generally be seen as reliable evidence, being documentary and from sources external to the entity. If the auditor had doubts as to the reliability of this evidence, it could be improved by the auditor originating similar evidence by means of a payables circularisation rather than relying on suppliers' statements received by the client.

Sufficiency

Suppliers' statements would generally be seen as reliable evidence, being documentary and from sources external to the entity. If the auditor had doubts as to the reliability of this evidence, it could be improved by the auditor originating similar evidence by means of a payables circularisation rather than relying on suppliers' statements received by the client.

3.4 **Appropriate – relevance**

The physical inspection of a non-current asset is clearly relevant to the auditor's opinion as to the existence of the asset, and to some extent the completeness of recording of assets; that is, the auditor can check that all the assets inspected have been recorded. In certain circumstances evidence relevant to valuation might be obtained; for example, where a client has written down a building due to impairment in value and the auditor sees it standing unused and derelict.

Appropriate – reliable

Physical inspection of a non-current asset is a clear example of auditor-originated evidence, so would usually be considered more reliable than that generated by others.

Sufficiency

Inspection of a non-current asset would be sufficient evidence as to the existence of the asset (provided it was carried out at or close to the end of the reporting period). Before concluding on the non-current asset figure in the accounts, the auditor would have to consider the results of their work on other aspects, such as the ownership and valuation of the asset.

3.5 **Appropriate – relevance**

The comparison of revenue and expenditure items with prior periods will provide evidence as to:

- completeness of recording, as omissions can be identified and investigated;
- accuracy, in cases where the auditor has appropriate information on which to base expectations, for example, if the number of workers has doubled during the year and a set percentage wage increase had been effected in the year; and
- presentation, as the comparison should highlight any inconsistencies of classification and treatment from year to year.

Appropriate – reliable

Analysis such as this comparison of revenue and expenditure items with the prior periods would again be termed auditor-generated evidence, and would be considered more reliable than evidence generated by others. Ultimately the reliability of such audit evidence depends on the reliability of the underlying data; this should be checked by tests of controls or substantive procedures.

Sufficiency

In addition to the general considerations, such as risk and materiality, the results of a 'comparison' alone would not give very persuasive evidence. It would have to be followed by a detailed investigation of variances (or lack of variances where they were expected). The results should be compared to the auditor's expectations based on their knowledge of the business, and explanations given by management should be verified. The persuasiveness of the evidence should be considered in the light of other relevant testing, for example tests of controls in payments systems and substantive testing of expense invoices.

3.6 **Appropriate – relevance**

The proof in total calculation will provide evidence as to the accuracy of the interest expense. Typically this would be calculated by multiplying the interest rate applicable to the loan to the average amount of the loan for the period. Any significant difference between the total calculated by the auditor and the amount in the financial statements would need to be investigated further.

Appropriate – reliable

As above, the proof in total would again be termed auditor-generated evidence, and would be considered more reliable than evidence generated by others. Ultimately the reliability of such audit evidence depends on the reliability of the underlying data. Timings of repayments would need to be considered when calculating the average level of the loan during the period and the interest rate would need to be agreed to the loan agreement.

Sufficiency

The interest payable on the loan is likely to be relatively low risk but could be material. The proof in total calculation may be sufficient evidence depending on the level of difference between the amount expected by the auditor and the actual amount. Any significant discrepancy would need to be investigated.

Answer to Interactive question 4

4.1 Factors to consider:

Materiality

Property, plant and equipment (PPE) is likely to constitute a material proportion of the assets in the statement of financial position of a manufacturing company. In addition, the depreciation charge may be material to profit.

Depreciation of plant and machinery is charged to cost of sales, and therefore has a direct impact on the gross profit margin of the business.

Inherent risk

Although PPE is generally regarded as having low inherent risk, the following factors may increase the level of risk for Xantippe Ltd.

- Additions to plant may be misclassified as repairs and recognised in profit or loss.
- Repairs expenditure may be capitalised in error.
- Depreciation has a direct impact on profit and can potentially be manipulated by changing the expected useful lives of assets.

Control risk

To determine the degree of reliance that can be placed on internal controls, the following will need to be examined.

- Authorisation of expenditure on new PPE
- Client procedures for periodic review of renewals/repairs accounts
- Client reconciliations between the PPE register and nominal ledger account balances

If reliance can be placed on the above controls, assurance will be obtained that:

- PPE additions are valid business items;

- capital expenditure has been included in PPE; and
- revenue expenditure written off PPE has been accurately recorded.

Strong controls, as confirmed by tests of controls, will enable the level of substantive procedures to be reduced.

4.2 Audit procedures:

Freehold property

- Agree opening balances to prior year working papers/financial statements.
- Inspect the title deeds to the property (or obtain assurance that they are held by the bank) in order to confirm continuing ownership.
- Inquire whether any valuations have been carried out in the year.
- If any valuation shows a fall in value, propose adjustment (if material).
- Inspect the property to confirm (existence) that no provision for fall in value is necessary.
- Confirm from the bank letter (and discussions with management) any charges on the property.
- Confirm all charges are properly disclosed in a note to the financial statements.
- Discuss with directors the reasonableness of their estimate of the useful life of the freehold buildings.
- Reperform the calculation of depreciation, ensuring that the freehold land is not depreciated.

Plant and machinery and motor vehicles

- Confirm opening balances to prior year financial statements.
- Obtain a list of additions in the year which reconciles with the total in the financial statements.
- For a sample of additions – trace to purchase invoices to confirm ownership – review board minutes/capital expenditure requisition for authorisation.
- Review the list of additions to ensure that all items are of a capital nature.
- For a sample of assets on the register, physically inspect to confirm existence.
- Inspect invoices for motor vehicle additions to confirm that capital cost includes VAT but excludes road tax.
- If motor vehicle additions involved a trade-in/part-exchange, discuss financial statement adjustments required with directors (since no disposals accounted for).
- Inspect vehicle registration documents to confirm ownership.
- Compare the depreciation charge (as a percentage of cost) on a category by category basis with that of the prior year to assess reasonableness.
- Reperform depreciation calculations for a sample of assets on the register.
- Obtain a list of disposals in the year which reconciles with the total in the financial statements.
- For a sample of disposals – trace sales proceeds to sales invoice and cash book – reperform calculation of profit on disposal and trace to statement of profit or loss and other comprehensive income.
- Review repairs and renewals accounts to ensure that no items of a capital nature have been written off.

Answer to Interactive question 5

Audit risks

- Revenue has increased by 15.6% as compared with 10 months to October 20X6. There is a risk that revenue is overstated. Investigations would be required as to why this increase has taken place. For example, it could be the result of a change in revenue recognition policy. Revenue may also have been affected by the translation of foreign currency sales which make up a significant proportion of total revenue. It may also be that sales prices have increased and the price lists should be reviewed for changes, including the dates when changes were made. This includes both official prices and discounting policy. It may also be that sales volumes or sales mix have changed. This should be reviewed against budgeted production.
- Gross profit margin has increased. This is because cost of sales has increased by only 7.2% compared to an increase in revenue of 15.6%. This may indicate that the increase in revenue was largely as a result of selling price increases (which would not be reflected in increased costs) rather than volume increases (which would have been reflected in increased cost of sales). This proposition would be true for a retail company but, as Darwin is a manufacturing company, there may be an alternative explanation. This is that cost of sales consists of both variable costs (eg, raw materials) and fixed costs (manufacturing overheads, such as factory rent). If sales volumes have increased significantly between 20X6 and 20X7 then, if fixed costs are significant, one would not expect costs of sales to vary proportionately with sales revenue, but would increase by a smaller percentage. The manufacturing cost structures would therefore need to be reviewed to formulate an expectation of the relationship between cost of sales and revenue when volumes increase.
- There is also a risk that revenue may be overstated due to accounting errors; for example, items in transit to overseas customers being included in both revenue and year-end inventories. This would be consistent with the increase in inventory balance. Alternatively, it could be the result of understatement of purchases.
- Changes in pricing strategy, sales mix or productivity would also have to be considered.
- Operating profit has increased and may be overstated. This could indicate understatement of operating expenses, for example through inadequate accrual for such expenses.
- Increasing inventory values.

  Assuming 360 days in a full year then inventory days have increased significantly:

  10 months to 31 Oct 20X6 4,320/14,966 × 300 days = 87 days

  10 months to 31 Oct 20X7 5,160/16,040 × 300 days = 97 days
- Inventory may therefore be overstated. This could be as a result of errors in the quantity of inventory held or errors/changes in the way the inventory has been valued.
- The business appears to be seasonal. In the 10 months to 31 October 20X6 the average monthly sales were £2,352,000. In the two months to 31 December 20X6 average monthly sales were only £1,776,000. The period to sell the inventory at 31 October 20X7 is therefore likely to be longer than would be implied by the average sales for the 10-month period, as two months of low sales are forthcoming if the pattern of 20X6 is to be repeated. This would imply inventory days of more than 97 days and thus impairment should be considered.

Answer to Interactive question 6

6.1 Observation/Impact

Observations	Impact on audit of trade payables
Gross profit margin has fallen from 24% last year to 21% this year.	Business strategy and performance must be discussed with the directors. The lower margin could arise from genuine business factors including some relating to payables such as: • new suppliers charging higher prices; and • increases in the cost of raw materials used by suppliers. These factors would have to be confirmed during the audit of payables.
Cost of sales has increased by 50% while revenue has increased by 45%.	Where the decline in margin cannot be adequately explained by business factors, accounting errors must be considered. These could include: • an inaccurate cut-off on goods received which misstates purchases and trade payables; and • misclassification between purchases and other expenses. Potential errors would increase the level of work required on payables.
Trade payables have increased by 38%, which is less than the increase in cost of sales.	The scope of circularisation and/or supplier statement reconciliation work may have to be extended if there is an increased number of suppliers, and these have not been recorded.
The trade payables payment period has been reduced slightly from 61 days last year to 56 days this year.	Information on payment terms with new suppliers (eg, for footwear) must be obtained to establish expectations. There is a risk of unrecorded liabilities (eg, due to omission of goods received not invoiced or inaccurate cut-off in the purchase ledger). Review of subsequent cash payments to payables should cover the two months after the year end.
Other payables have risen by 12% – this does not seem consistent with a reduction in the number of shops.	Payables for purchases may be misclassified as other payables.

6.2 Use of audit software

Reperformance of calculations:

- To cast the trade payables ledger file balances for comparison of the total with the balance on the control account in the general ledger.
- To check arithmetic accuracy of individual suppliers' accounts.
- Analytical procedures:
- To calculate the payment period by supplier.

C H A P T E R

6

- To compare the current year balances with the prior year balances of the major suppliers at each year end, and report any significant changes for further review.
- To determine the percentage increase or decrease for each account and in total.

Selection of data for substantive procedures:

- To select, from purchase records, a sample of suppliers for circularisation or review of supplier statement reconciliations.
- To produce a printout of the major trade payables at the year end.
- To produce an exception report of debit balances on the payables ledger.
- To select, from inventory records, receipts immediately before the year end for matching to goods received not invoiced accruals/trade payables.
- To identify unusual transactions (eg, relating to capital acquisitions through hire purchase agreements).
- To identify unusual standing data (eg, accounts for inactive suppliers).

Selection of representative samples for tests of controls:

- Of purchases – to test whether they are properly authorised and matched to goods received notes.
- Of payments – to test whether they are authorised.

Payables circularisation:

- To print requests for statements, monitor replies and produce second requests.

Cut-off:

- To identify goods received documentation unmatched on file, for verification of inventory/payables cut-off.
- To select post year end payments for verification of cash/payables cut-off.

Disclosure:

- To extract total debits to the purchases accounts and total credits in individual suppliers' accounts for comparison and reconciliation.
- To search 'other payables' for:
  - individually significant balances; and
  - names of trade payables.

Answer to Interactive question 7

Gearing ratios

Gearing = Debt ÷ (Debt + Equity)

(1) Book values

(250,000 + 150,000) ÷ (400,000 + 600,000) = 40%

(2) Market values

	£
Equity (V_e) 1,000,000 × 125p	1,250,000
Preference (V_p) 250,000 × 65p	162,500
Loan stock (V_d) 150,000 × 85%	127,500
	1,540,000

(162,500 + 127,500) ÷ 1,540,000 = 18.8%

Comment

There is a significant difference between the book and market values. In particular, the market obviously places value on the equity of the business, showing a potential confidence in the company's future. On a market-based measure, gearing appears to be low and would seem acceptable, although we have no external data to validate this.

Working capital ratios

Receivable days = (150,000 ÷ 2,000,000) × 365 = 27 days

The jewellery is sold 27 days (on average) before payment is received. Given the high value of items, there is a high risk of bad debt. Care must be taken to ensure that credit is granted only to creditworthy clients.

Payable days = (100,000 ÷ 1,200,000) × 365 = 30 days

Harrison plc pays its suppliers after 30 days (on average). This seems a reasonable amount of time, and there seems to be no pressure on liquidity from this perspective.

Inventory days = (300,000 ÷ 1,500,000) × 365 = 73 days

Inventory days seem high at 73 days. However, a wide range of different items need to be displayed in order to attract customers into the shop.

Many items, however, will be made to order, and this should be encouraged – it will help to reduce the number of inventory days.

Non-financial measures

These include the following.

- Daily number of items sold
- Repeat business/customers
- Customer satisfaction
- Time taken for 'made to order' items
- Number of repairs/faulty items sold

These types of measures are important for Harrison plc, as the volume of trade will be relatively small on a daily basis. Each extra sale will generate extra profit, and hence keeping customers happy and satisfied will improve the overall performance of the shop.

Answer to Interactive question 8

8.1 Platforms

It is not necessary to use an auditor's expert to audit the useful lives of the platforms, as there are many other available sources of evidence. Relevant procedures include the following:

- Obtaining weather reports to see whether management's determination of useful lives is consistent with them
- Comparing budgeted oil against actual oil extracted (if the budget was optimistic, so might the useful life be)
- Reviewing published industry comparators (such as Shell and BP); if the useful lives of their platforms as published in financial statements is significantly different, discuss with management why that might be
- Considering whether management's determination of useful lives in the past has been proved accurate

8.2 It is not necessary to use an auditor's expert, as the question states that a 'simple' test is available. The auditors should confirm that the company will be making use of this test during the inventory count to separate the inventory. The auditor should reperform the test on a sample of brass and copper as counted to ensure they have been separated correctly.

Answers to Self-test questions

1 **Strombolix plc**

BRIEFING NOTE

To Charles Church (partner)

From A Senior

Date 25 July 20X2

Subject Strombolix audit

Issues on the audit to date

(1) **Trade receivables Issues arising**

One type of paint has suffered problems of decay after only a short period of use, and customers are refusing to pay for recent deliveries. If these claims are valid (as would be indicated by the fact that the complaints are coming from several different independent sources) this creates a number of issues.

- The most obvious issue is assessing the need to make provision against, or write off, the £50,000 of receivables relating to the claim. If the claim is valid the receivables should be written off immediately.
- Given that the decay only occurs after a few months, at least some of the paint is likely to have been paid for already: thus repayment in respect of these sales is due. Under IAS 37, *Provisions, Contingent Liabilities and Contingent Assets* an obligating event has occurred (the sale of faulty paint) and there is a probable transfer of economic benefits which can be reasonably estimated.
- Provision will also need to be made against any inventories that may be held of this type of paint, as they cannot be sold if faulty. This should include any disposal costs.
- If wholesale customers of Strombolix are being sued by their own customers, it is very probable that they will in turn consider litigation against Strombolix. Part of any claim will be for the paint itself for which provision is to be made as suggested above. Additionally, however, there is likely to be a claim for the labour cost involved for the removal of the old paint, in applying new paint and for disruption. Consideration should be given to making provision for these amounts, but they are more uncertain in their nature, not least because there does not currently appear to be any such legal claim against Strombolix. The situation will need to be monitored up to the time of audit clearance to reassess the situation at that date.
- If wholesale customers of Strombolix are being sued for the faulty paint, consideration should also be given to making similar provisions in respect of the sales by Strombolix of the paint to its own retail customers.
- The necessary provisions are specific provisions and would be allowable for taxation. The tax charge for the year would therefore need to be adjusted to the extent of any provisions made. The deferred tax charge would need to be adjusted accordingly.

Audit procedures

The key audit issue is to establish whether there is a technical fault in the paint. If there is, as seems likely, then it will be necessary to establish the extent of the problem by ascertaining the following in respect of this particular paint.

- The amount of receivables outstanding
- Total sales to date to wholesale and retail customers
- Amount of the paint in inventories
- Review any correspondence on the issue
- Review correspondence with the company's solicitors
- Establish whether Strombolix made the paint itself or whether it was purchased from a supplier, in which case there may be a corresponding claim by Strombolix
- Speak to the company's production/technical director to establish the nature of the problem and whether any other paints may be affected
- Attempt to estimate the non-material costs which customers may incur in replacing the faulty paint
- Review returns inwards and customer compliant files from retail customers in respect of the faulty paint
- Review the latest situation with respect to litigation on a continuing basis up to the time of audit completion

Questions for finance director

- Does the company accept that it was at fault with respect to this paint?
- What attempts have been made to evaluate liability?
- What is the current status of any litigation against the company?

(2) Inventories Issues arising

A special retail offer of '3 for 2' on wallpaper purchased from an outside supplier during the year has been incorrectly recorded, as the offer was not programmed into the company's IT system. The company also intends to take credit for a proportion of a quantity bonus payable by the supplier in respect of this product.

There are two key audit issues.

- There has been a systems error which appears to have gone undetected and unreported for some time. This raises concerns about the operation of the accounting and internal control systems more generally.
- The extent of the substantive errors needs to be established and adjusted.

Systems errors – inventories

- Establish why the special offer was not programmed into the IT system.
- Establish whether any other such programming omissions occurred.
- Investigate why the error was not reported back to programmers from store managers who were instructing sales staff to read only two of the three items.
- Consider the level of understanding of store managers of the IT system, and whether this may have contributed to other similar errors.
- Establish how the error was ultimately detected, and thus what other controls had failed to detect the problem before its discovery.

Substantive errors – inventories Misstatement relating to special offer

- If the third item in each transaction was unrecorded, the IT records will overstate inventory. If 20,000 units have been recorded (if they have all been sold through the special 3 for 2 offer) 10,000 have been unrecorded. This will mean reducing inventories in the IT records by a maximum of £50,000.
- Adjustment will need to be made for any similar errors discovered by the above systems review.

Taking credit for bonus

- Strombolix appears to be intending to take credit for part of the supplier's bonus in its draft financial statements. The bonus is, however, effectively a contingent asset under IAS 37, as the payment is dependent on making total sales of 40,000 units, including some in the future. If this is only probable, disclosure can be made, but a pro rata amount cannot be included in the statement of profit or loss and other comprehensive income in the year to 30 June 20X2.
- If,on the basis of post year end evidence before audit completion, it is virtually certain that sales of 40,000 units of the product will be made, and that settlement will be made by the supplier, then a pro rata recognition is appropriate. However, as the sales appear to be made on the total level of sales made by the supplier to Strombolix (ie, including the 'free' goods and perhaps any goods still in inventories), then the credit would be a maximum of £67,500 (ie, (30,000 ÷ 40,000) × £90,000) if all sales were through the special offer.
- In the absence of near certainty over attaining the bonus, there is an inventory valuation problem. If the bonus is not paid, the NRV of any inventories remaining is less than its cost. For example, a batch of three units would be valued in inventories at £15 (3 × £5), whereas its NRV is only £12 (2 × £6). In this case, consideration should be given to writing down each inventory item to £4 (ie, £12 ÷ 3).

Audit procedures

- Obtain explanations for the systems error.
- Review the company's internal control procedures with respect to the inclusion in the IT system of non-standard sales arrangements.
- Obtain explanations for the non-reporting of the error by store managers.
- Review the scope for similar errors in the system in respect of both detection and reporting.
- Consider whether (and if not, why not) the physical inventory count detected the IT error.
- Evaluate the number of sales of the product made through the '3 for 2' special offer, as opposed to single purchases.
- Review post year end sales to assess the probability of achieving the bonus payment from the supplier.
- Consider the adequacy of the inventory provision in the light of the results of the above.

Questions for finance director

- How did the systems error occur in respect of the special '3 for 2' offer?
- Why did it go undetected?
- What is the justification for taking credit for part of the bonus from the supplier when the target has not been achieved at the year end?

(3) Capitalisation of interest Issues arising

The company had a new superstore constructed during the year, and it borrowed to finance this project. The interest on the borrowing was all capitalised.

IAS 23, *Borrowing Costs* requires borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset to be capitalised as part of the cost of the asset. It defines a qualifying asset as one that takes a substantial period of time to get ready for its intended use or sale (IAS 23.5). The treatment adopted by the company therefore appears to comply with the IAS providing that the borrowing costs are 'directly attributable' to construction ie, they would have been avoided if expenditure on the construction of the asset had not been incurred.

The finance costs on the relevant borrowings become part of the overall asset and are therefore recognised in profit or loss as the asset is depreciated over its useful life, rather than as incurred.

Capitalisation should cease when substantially all the activities necessary to get the asset ready for its intended use or sale are complete (IAS 23.22). It is the availability for use which is important, not when it is actually brought into use. An asset is normally ready for its intended use or sale when its physical construction is complete.

It would appear that the interest capitalised in respect of the new superstore is as follows.

Period	Payment for	Calculation capitalised	Interest
			£
1.8.X1–30.6.X2	Land	11/12 × £400,000 × 8%	29,333
1.12.X1–30.6.X2	Progress payment	7/12 × £1m × 8%	46,667
1.6.X2–30.6.X2	Progress payment	1/12 × £1m × 8%	6,667
			82,667

Assuming that commencement of preparation for planning permission was the earliest date at which the company commenced to 'get the asset ready for use', then the correct interest to be capitalised is as follows.

Period	Payment for	Calculation capitalised	Interest
			£
1.9.X1–30.5.X2	Land	9/12 × £400,000 × 8%	24,000
1.12.X1–30.5.X2	Progress payment	6/12 × £1m × 8%	40,000
			64,000

The difference of £18,667 (£82,667 – £64,000) should be treated as a cost for the year in the statement of profit or loss and other comprehensive income under 'finance costs'. There should also be a corresponding deduction from the cost of the asset in the draft financial statements.

The amount of borrowing costs that must be capitalised is limited by the requirement that the total value of the asset (including borrowing costs) should not exceed the asset's recoverable amount.

The following disclosure should be made where interest is capitalised within non-current assets.

- Aggregate finance costs included in non-current assets
- Finance costs capitalised in the year (including £64,000 in respect of this transaction)
- Finance costs recognised in profit or loss (including £18,667 in respect of this transaction)
- Capitalisation rate used (8%)

Audit procedures

- Loan agreement to be inspected for interest rate and other terms
- Contract for building the superstore and associated documentation to be inspected – particularly for amounts and dates in this context

- Evidence of the date on which activity commenced to 'get the asset ready for use' to be inspected eg, preparation for planning permission
- Evidence of the date on which the asset was ready for use to be gathered (eg, builder's reports and other correspondence)
- Confirm that the policy on interest capitalisation is consistent with that previously adopted when building other stores

Questions for finance director

- Why was there a delay between the purchase of land and the commencement of preparation for planning permission?
- Does he accept that the revised calculation (above) is consistent with IAS 23?

General concerns arising from the takeover bid

The takeover bid is an inherent risk in the context of this audit, particularly as the directors are attempting to defend the bid. In this case they will be attempting to show the company in the best possible light. This may involve disclosing the highest possible profit in the financial statements.

This policy would be consistent with the audit issues discovered, in that there does not appear to be any provision in respect of receivables or inventory in audit issues (1) and (2). Similarly, the amount of interest capitalised in (3) appears to present an overoptimistic figure for profit.

Consideration will thus need to be given to the extent of reliance that can be placed on management assurances and managerial control in this audit, even if they have proved reliable in the past.

Moreover, if the financial statements are misstated there is a possibility of litigation against our firm for third-party negligence if Simban suffers a loss or if it relies on the financial statements – and we know it is relying on the financial statements for the purpose of the takeover. To some extent a report of due diligence before takeover may mitigate some of this risk, but this cannot be relied on entirely.

Consider the impact of time pressure being placed on the audit.

Reconsider materiality levels and the risk assessment in the audit plan in the light of the takeover bid.

2 AB Milton Ltd

2.1 Potential related party transactions

Person/entity	Related party	Why	Transaction
Alexander Milton	α	Director	No transactions mentioned
Brian Milton	α	Director	No transactions mentioned
Brian's wife	α	Wife of director	
Edward Murray	α	Director	Purchases of stationery
Murray Design	α	Entity controlled by a director	
Diane Hardy	×	No longer close family and does not have control or significant influence	
Fiona Dyson	α	Presumed close family and shadow director	Contracts drawn

Person/entity	Related party	Why	Transaction
Cuts and Curls	?	(see below)	Rental agreement
Campbell Milton Roofing	α	Sub of AB Milton	Work done for AB (see below)
Ian Campbell	α / ×	Could be considered key management of group	

Cuts and Curls is not clear cut. For it to be a related party Gillian Milton would need to be in a position to control Cuts and Curls and then due to her relationship with Alexander Milton her company would come under the related party umbrella. Gillian only holds 50% and therefore holds joint control with her mother.

Disclosure

The related party relationship between AB Milton and Campbell Milton Roofing must be disclosed, as it is a relationship between a parent and a subsidiary. This disclosure must be provided irrespective of whether a transaction takes place.

For other related party relationships disclosure is only required where a transaction has taken place. In this case that would apply to the transactions with Edward Murray, Fiona Dyson and potentially Cuts and Curls. Disclosure is required of the nature of the related party relationship as well as information about the transaction and any outstanding balances necessary for users to understand the potential effect of the relationship. Disclosure should include the following as a minimum:

- A description of the relationship
- A description of the transaction and the amounts included
- The amounts due to or from the related party at the end of the year
- Any other element of the transaction necessary for an understanding of the financial statements

2.2 Notes for staff training sessions:

(a) We are required to assess the risk of undisclosed related party transactions and to design our audit procedures in response to that risk. A logical place to start the audit of related party transactions would be to identify all possible related parties. This would always include the following:

- Directors and shadow directors
- Group companies
- Pension funds of the company
- Associates

It is likely that the other related parties would include the following:

- Key management (perhaps identified by which staff have key man cover)
- Shareholder owning > 20% of the shares
- Close relatives and associates of any of the above

All related party transactions must be disclosed. Related party transactions do not necessarily have to be detrimental to the reporting entity, but those which are will be easier to find. The following features, among others, may indicate this:

- Unusually generous trade or settlement discounts
- Unusually generous payment terms
- Recorded in the nominal ledger code of any person previously identified as a related party (for example, director)

- Unusual size of transaction for customers (for example, if the company were paying a suspiciously high legal bill for a building company)

(b) Audit procedures to identify related party transactions are as follows. Risk assessment procedures:

- Discussion by the audit team of the risk of fraud-related misstatements
- Enquiries of management
- Obtaining an understanding of the controls in place to identify related party transactions

Other procedures might include:

- Identification of excessively generous credit terms by reference to aged trade accounts receivable analysis
- Identification of excessive discounts by reference to similar reports
- Scrutiny of cash book for payments made to directors or officers of the company (probably more realistic for smaller entities)
- Review of board minutes for evidence of approval of related party transactions (directors are under a fiduciary duty not to make secret profits)
- Written representations from directors to give exhaustive list of all actual/potential related parties (that is, allow us to make the materiality assessment, not them)
- Review of accounting rewards for large transactions, especially near the year end and with non-established customers/suppliers
- Identification of any persons holding > 20% of the shares in the entity by reference to the shareholders' register

3 TrueBlue Ltd

3.1 Discussion with the finance director Revenue and marketing expense

The trend of falling revenue has continued in 20X7 from previous years. The problem seems worse in view of the fact that 20X7 saw a substantial increase in advertising and marketing expenditure, without which the fall would presumably have been greater. It is important to investigate this situation and the action taken in relation to it, because the company could be facing significant going concern problems if its products are no longer required by the market. However, the revenue fall in 20X7 from 20X6 is not as significant as from 20X5, and it is possible that the sales trend in 20X6 and the beginning of 20X7 has been reversed and the company might be beginning to perform well again.

Additional information required:

- Does the additional marketing spend relate to 20X7 or was it to encourage sales in the future?
- Were there any sales forecasts produced in connection with the marketing spend?
- Can you provide details of sales month by month to show the revenue pattern throughout the year, particularly in relation to the marketing spend?
- Does management have other plans/intentions with regard to boosting revenue, particularly if the additional marketing spend in 20X7 has not produced the expected results?

Gross profit percentage

The gross profit percentage was stable in 20X6 and 20X5 at 30% but it has dropped in 20X7 to 23%. This implies either that there is a mistake in the figures (for example, an expense may have been analysed incorrectly; there may have been an error in final inventory counting or valuation; or some sales may not have been included correctly in revenue hence it has fallen), or that there has been a change in the cost structure or sales mix resulting in this fall.

With revenue falling, if sales are also becoming less profitable, the problem outlined above might be intensified. Alternatively, a new sales mix may be the directors' approach to solving revenue fall and, in the long term, increased sales at a lower margin might be the new situation for the company.

Additional information required:

- The reason for the fall in gross profit percentage
- Analysis of sales by month and product
- Further analysis of cost of sales figures

Receivables

The trade receivables balance has fallen over the three years, which is in line with the fall in revenue. However, it has not fallen at the same rate, which is shown by the fact that the receivables days calculation shows that debts are now taking six more days to collect than they were in 20X5. The significant change occurred in 20X7, with the day calculation falling from 63 to 67 days in 20X7 as opposed to 61 to 63 in 20X6.

The increase could be caused by any of the following factors.

- The marketing event has caused a change in sales patterns/debt collection later in the year (this would be revealed by analysing detailed sales information outlined above).
- Problems with credit control/the company has uncollectible debts on the ledger that should realistically be written off.
- It is possible that a receivables ledger fraud is being carried out.

Credit control problems would constitute a control deficiency that the auditors should note and respond to with regard to their audit. They should assess whether the problems with control extend further than the credit control department, as widespread control issues could significantly affect risk assessment.

If there is a large amount of old debt on the ledger, a truer picture would be presented if it were written off. Similarly, a fraud being carried out on the ledger would affect the true and fair view. Four days represents 1% of the year, and therefore 1% of revenue (taken on an average basis) and it is therefore a material issue.

Further information required:

- Aged analysis of the receivables ledger to identify whether any significant aged debts exist which require writing off
- Remittance advices from customers to assess payment patterns

Inventory, cash and liquidity

The inventory movement assessment in the cost of sales analysis shows that inventory levels at the company have risen consistently at the company over the last three years so that the inventory balance is now £3 million higher than at the start of 20X5. Direct production and purchase costs have remained stable over those years, suggesting that operation levels have not changed to reflect the situation in the market and the falling sales position. This is likely to have had a devastating impact on the cash position of the company. The statement of financial position will show a significantly illiquid position with an inventory pile and a decrease in receivables conversion rate. If it also shows a significant cash deficit then there are immediate concerns about whether the company can continue to finance operations.

Further information required:

- Production levels in 20X7 and management's future intentions concerning production
- Bank statements and statements of cash flows and projections
- Inventory sheets from 20X7 count
- Inventory valuation sheets from 20X7

Other expense items

The other expense items provided in this analysis are immaterial in relation to revenue and therefore the auditor would not focus on them at the planning meeting.

WORKINGS

(1) Gross profit margin

20X7

4,357,233 ÷ 18,944,487 = 23%

20X6

6,174,827 ÷ 20,588,370 = 30%

20X5

7,359,648 ÷ 24,536,570 = 30%

(2) Receivables days

20X7

(3,477,481 ÷ 18,944,487) × 365 = 67 20X6

(3,553,609 ÷ 20,588,370) × 365 = 63 20X5

(4,089,783 ÷ 24,536,570) × 365 = 61

(3) Payables days

20X7

(1,056,090 ÷ 9,183,388) × 365 = 42 20X6

(1,027,380 ÷ 9,246,420) × 365 = 41 20X5

(1,164,843 ÷ 10,483,588) × 365 = 41

3.2 If fraud is suspected

The auditor is required to approach their task with an attitude of professional scepticism. Therefore, in theory, the auditor should not approach the task differently if fraud has been suggested than they would have before. The questions arising from the analytical procedures would be the same, and the auditor would still seek to corroborate the answers and then assess whether they are satisfied with the corroborated answers. Given that the auditor is required to be aware that fraud is a possibility whether they have been tipped off or not, the corroboration of the finance director's answers should have been thorough and based on sources other than the finance director (such as third-party invoices and the opinions/experience of other sources in the company) anyway.

If the auditor has been given a tip off that fraud exists, he should pass on that information to the appropriate level of management. In this case, this would be the audit committee, as the tip off concerns the finance director.

3.3 Approach to the audit of receivables

There is a good source of third-party evidence in relation to the receivables balance; that is, the customers. Usually trade receivables is audited by means of direct confirmation. It is likely that the receivables balance at TrueBlue has been audited by a receivables confirmation in previous years and, if there is a fraud being carried out on this balance, then it has not been uncovered by the audit procedures. It is possible that the audit procedures have become repetitive, that the same (largest) customers have been selected to test year on year and that the finance director has been able to carry out a small scale fraud on smaller balances less likely to be tested, or that the fraud has only been carried out in the current year.

The auditors should carry out a receivables confirmation in this year, as it is the best source of audit evidence. They should increase the sample size to reflect the risk associated with the balance and extend testing to a larger number of customers than has previously been the case.

In addition, the auditors should carry out some transaction testing on sales receipts in the year, tracing the transactions through the system and trying to match receipts with invoices on the sales ledger.

If a fraud has been carried out in this area it casts significant doubt on the controls in this area and the auditors should consider whether controls throughout the accounting function might also not be operating effectively and what impact that has on the rest of the audit.

4 Tofalco plc Memorandum

To Paul Sykes

From Jeremy Wiquad

Date 6 November 20X0

Re Tofalco plc

The memo below covers the financial reporting and auditing issues raised per your request.

Financial reporting treatment and audit procedures required

- **Construction contracts**
  - Given that the outcome cannot be foreseen reliably, no profit should be recognised in the current year. Instead, £400 million should be recognised within cost of sales and, assuming that these costs are recoverable, the same amount within revenues (therefore showing no profit and no loss). The value of the work done in the statement of financial position will therefore be £400 million.

  Audit procedures to gain assurance include:
  - reviewing the contract to confirm the duration and sales value of the contract;
  - reviewing the surveyor's report to confirm the value of the work performed to date;
  - examining internal cost reports and confirming items on a sample basis to invoices; and
  - obtaining a written representation from management with regards to the outcome of the contract.
- **Provisions** – An environmental provision for the £2.5 million present value of the cost of disposing of the machines is required per IAS 37 and should be presented within non-current liabilities. This cost should also be included as part of the cost of the asset. In subsequent years the liability will increase due to the unwinding of the discount and a corresponding finance expense will be shown within profit or loss.

Audit procedures to gain assurance include:

- reviewing the law with regards to the environmental provision and the underlying documentation relating to the £2.5 million estimate provided;
- assessing whether the discount rate used to calculate the present value of the disposal costs is appropriate; and
- discussing with management if there are other areas/machines that require equivalent 'environmentally friendly' costs and that these have been provided for. Include the completeness of these provisions in the company management representation letter.

- **Receivables** – Per IFRS 9, *Financial Instruments* (see Chapter 16), receivables are a financial asset and it appears that an impairment of receivables (the specific debt of Stirly plc) may be needed.

  Audit procedures to gain assurance include:

  - attempting to review board minutes and the correspondence file for any discussion of this issue; and
  - reviewing subsequent events for payment of the amount due.

- **Assets held for sale** – According to IFRS 5, assets are classified as 'held for sale' when, among other criteria, management are committed to the sale and the asset is available for immediate sale. The situation is not entirely clear, but the criteria are probably not fully met until February 20X0, when the recoverable amount is £1.7 million. Therefore an impairment adjustment of £0.4 million is required on the transfer of the asset to the held for sale category. The fact that the building had not been sold by September is not necessarily a concern, as 12 months have yet to elapse. However, this will be a matter for review next year.

  Audit procedures to gain assurance include:

  - reviewing management documentation (eg, correspondence with estate agent and minutes) which confirms management commitment to sell;
  - checking the building is available for sale and not being used internally by the company;
  - checking the selling price is close to the market value of the buildings in the immediate area; and
  - checking the building is advertised for sale and for immediate transfer.

- The **issue of convertible loan stock** constitutes a compound financial instrument which needs to be split between its liability and equity components for presentation in the statement of financial position.

	£
Face value of convertible bonds	18,000,000
PVs of future cash flows of equivalent bonds with no conversion option	16,862,000 Liability
Equity (warrants) (difference between the above)	1,138,000 Equity

- Audit procedures to gain assurance include:

  - reviewing the convertible bond certificate for the face value, interest and conversion terms; and
  - recalculating the present value of the cash flows relating to the equivalent bond without conversion options.

- **Related parties** – As per IAS 24, given the materiality of the transactions involved, all details of the relationship between Tofalco plc and Sandstone Ltd need to be disclosed along with the particulars of the transactions within the notes to the financial statement.

Audit procedures to gain assurance include:

- obtaining a written representation from management that all related parties have been disclosed; and
- reviewing invoice file to ensure that all transactions with Sandstone Ltd have been disclosed.

Effects of non-compliance on the audit risk and form of the auditor's report

- Refusal to provide full details means that we are unable to obtain sufficient appropriate evidence (a limitation on the scope of the audit). If the effect is deemed material, an 'except for' qualified opinion is given. If the effect is deemed 'pervasive', then a disclaimer of opinion is made to the effect that "We do not express an opinion …"
- Failure to disclose full remuneration constitutes a material misstatement (disagreement) in respect of a legal issue (we conclude that the financial statements are not free from material misstatement) and materiality by size is not a factor in this area. As the matter is material irrespective of the sums involved, then an 'except for' qualified opinion will be given.
- Refusal to recognise obligations under IAS 37 constitutes misstatement (disagreement). In the event that these costs are material, an 'except for' qualified opinion is required. In the event they are deemed pervasive, then an adverse opinion is required stating that the financial statements 'do not give a true and fair view'.

Terms of reference of working relationship with Investo Ltd

Terms need to cover key investment risks (eg, Tofalco must set guidelines and approve investment policy).

Internal controls with regards to the operation of the relationship (eg, weekly statements sent to company reconciled with third-party information – eg, contract notes, share certificates, stock exchange confirmation).

Value for money – fee comparability and return.

Impact on future audits

- Future audits will need to include procedures that address the fact that investment activities are outsourced to Investo.
- In reaching preliminary risk assessments, assessments will need to be made of the inherent, detection and control risks related to the investments balance and the terms of reference the client has with Investo Ltd.
- Controls and processes carried out by Tofalco in relation to Investo's services will need to be documented and tested (and if the risk is great enough, those present at Investo also).
- The investments balance may also require substantive testing and so the need to obtain underlying source documentation from Investo Ltd.

Ethical considerations

- Management integrity appears to be questionable in this assignment. Management will need to understand the importance of their behaviour and its implications on the audit and the relationship with the auditor.
- There appears to be non-compliance with the law with regard to environmental regulations and the disclosure of remuneration paid to related parties. These issues are non-negotiable and will lead to a modified audit opinion if not addressed by management.
- We should consider whether it is appropriate for us to accept this assignment given the problems outlined above. If we do decide to resign, we need to follow legal and professional procedures – eg, submitting a statement of circumstances to an AGM and addressing the AGM (if we wish).

Chapter 7

The statutory audit: evaluating and testing internal controls

Introduction

Learning outcomes

- Analyse and evaluate the control environment for an entity based on an understanding of the entity, its operations and its processes
- Evaluate an entity's processes for identifying, assessing and responding to business and operating risks as they impact on the financial statements
- Appraise an entity's accounting information systems and related business processes relevant to corporate reporting and communication including virtual arrangements and cloud computing
- Analyse and evaluate strengths and weaknesses of preventive and detective control mechanisms and processes, highlighting control weaknesses; including weaknesses related to cyber security and corporate data controls
- Evaluate controls relating to information technology and e-commerce; including controls associated with cyber security and corporate data security
- Explain and appraise the entity's system for monitoring and modifying internal control systems
- Devise, explain and evaluate tests of controls
- Explain the respective responsibilities of those charged with governance and auditors in respect of internal control systems

Specific syllabus references for this chapter are: 12(a)–(g), 13(h)

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	**Introduction** You need to remember the importance of internal controls and how they are relied upon by both the audited entity and the auditors themselves as part of sound governance.	**Approach** Be prepared to refer to earlier parts of the study materials. **Stop and think** Can you remember where we previously discussed internal controls?	This section is a reminder that you must always study your materials holistically and not consider each part in isolation.	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive questions
2	**Respective responsibilities of those charged with governance and auditors** An awareness of these responsibilities will assist the auditor in focusing on the controls necessary for the creation of the financial statements.	**Approach** Work through this section with the auditing standards open book in front of you. **Stop and think** Did you remember all of the various definitions given here?	You may be asked to explain these responsibilities and why they are different to a junior member of staff.	N/A
3	**Evaluating and testing internal controls** You should be able to use tests of control as sources of valuable audit evidence.	**Approach** This will be revision from your previous studies. **Stop and think** Can you remember where you met this content before?	You should use the section on 'tests of controls' as a good recap of the type of audit procedures that a good test of control would contain.	N/A
4	**Service Organisations** If your audit client has outsourced some key financial functions, how do you make sure that you can still get the necessary audit evidence for your opinion?	**Approach** Work through this section with the auditing standards open book in front of you. **Stop and think** Can you tell the difference between type 1 and type 2 reports and do you know when each would be required?	Exam questions that test this content will be easy to spot but you will still need to explain first how service organisations create additional audit risk before you describe the impact it would have on your audit approach.	N/A
5	**Internal controls in an IT environment** When an entity uses IT systems that the auditor needs to access, the auditor needs to understand the various controls in place that govern	**Approach** While this may be revision, it is still important to be able to differentiate general and application controls. **Stop and think** You should consider how cutting edge	While there may be some IT-specific aspects that you will need to explain in an exam question (such as general and application controls that may be necessary in a given scenario) you may also be asked to	N/A

CHAPTER 7

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	the way the IT works, regardless of the data being processed and stored.	technology like data analytics fits into the traditional definition of CAATs.	discuss the impact that introducing new technology (such as cloud computing) might have on a client and its accounting systems.	
6	**Cyber security and corporate data security** This is vital area for all professionals, not just those who work in finance.	**Approach** Work through this section, paying particular attention to the content on GDPR and the advice on how to protect yourself from cyber threats. **Stop and think** Can you think of a situation that either you or an organisation you are familiar with was affected by any of these issues?	Questions on this topic could take many forms, such as an assessment of how well-prepared an organisation is (or is not) against some form of cyber attack, or requesting advice on how an organisation could implement such procedures.	**IQ1: NewForm Ltd** Use this as good practice for evaluating the audit risks from an IT-based environment and explaining how IT application controls can be used in a specific part of the organisation's systems.
7	**Communicating and reporting on internal control** Although the main purpose of the audit is not to identify deficiencies in internal control, should any be identified as a result of the audit work completed, the auditor needs to pass this information on to those charged with governance.	**Approach** You covered this in your previous studies so this should be revision. **Stop and think** Can you explain what makes a deficiency in internal control significant?	You may be asked to explain deficiencies in internal control so make sure you can communicate the reasons why they are deficiencies and what the audited entity should do to address them.	N/A

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Introduction

Section overview

- An entity's system of internal controls informs the auditor's assessment of audit risk and the nature of the audit procedures that would be undertaken during the audit fieldwork stage.
- In addition to the auditing standards, corporate governance codes (such as the UK Corporate Governance Code and the Sarbanes–Oxley Act) also prescribe the respective responsibilities of the auditor and those charged with governance with regards to internal controls. However regulations such as the Sarbanes–Oxley Act has not yet been enacted in Bangladesh.

Internal control is an essential aspect of the entity about which the auditor must gain an understanding at the start of the audit. The effectiveness of the system of internal controls informs the auditor's risk assessment and, consequently, the audit procedures to be carried out at the audit fieldwork stage. Therefore, internal control will have to be considered throughout the audit life cycle
– from planning to finalisation and reporting.

In this chapter, we will revise the auditor's responsibilities with regards to the system of internal control and the consideration of internal controls at different stages of the audit. We will then have a closer look at the implications of service organisations, and the risks and benefits of internal controls in an IT environment.

As you will have seen already, internal control is central to corporate governance. Therefore, we will regularly refer back to our discussions on corporate governance in Chapter 4.

2 Respective responsibilities of those charged with governance and auditors

Section overview

- Auditors are responsible for obtaining audit evidence that provides reasonable assurance that the financial statements are free of material misstatements, some of which may be caused by error.
- Management are responsible for designing and implementing a system of internal control which is capable of preventing, or detecting and correcting, errors in the financial records.
- Auditors are required to assess the system of internal control as part of their audit in order to determine whether to rely on the system of controls or carry out extended tests of details.

2.1 Responsibilities of those charged with governance

As you no doubt already know, the responsibility for the design, implementation and maintenance of an effective system of internal control, one that is capable of preventing, or detecting and correcting, errors in the financial records, lies with those charged with governance (TCWG).

Let's revise some key definitions.

Definitions

Those charged with governance: The person(s) or organisation(s) (for example, a corporate trustee) with responsibility **for overseeing the strategic direction** of the entity and obligations related to the **accountability** of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.

Those charged with governance generally include executive and non-executive directors and the members of the audit committee.

Error: An unintentional misstatement in financial statements, including the omission of an amount or a disclosure.

Internal control: A process designed, implemented and maintained by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. It follows that internal control is designed and implemented to address identified business risks that threaten the achievement of any of these objectives.

2.2 Auditor's responsibilities

As we outlined in your earlier studies, the auditor is required to do the following:

- Assess the system of internal controls to determine whether they are capable of preventing or detecting and correcting errors (ISA 315)
- Test the internal controls if required (ISA 330)
- Report deficiencies in internal control to TCWG where they have been identified (ISA 265)

As part of assessing the system of internal controls as part of audit risk assessment, the auditor must do the following:

- Obtain an understanding of controls relevant to the audit
- Evaluate the design of those controls
- Determine whether they have been implemented

The auditor must then test controls if:

- the auditor intends to rely on the operating effectiveness of those controls; or
- substantive procedures alone cannot provide sufficient, appropriate audit evidence.

Finally, the auditor must determine whether the audit work has identified any deficiencies in internal control and, where these deficiencies are significant, communicate the significant deficiencies to TCWG in writing on a timely basis.

In the following sections, we will look at each of these stages in further detail.

Effective internal controls form a crucial part of good corporate governance. For a more detailed discussion on the importance of internal controls, and the auditor's role in relation to internal controls, please refer back to Chapter 4.

3 Evaluating and testing internal controls

Section overview

Sources of audit evidence include tests of controls.

3.1 Evaluation of internal controls for audit purposes: revision

Understanding an entity's internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement, and in designing the nature, timing and extent of further audit procedures.

Step 1 Initially, the auditor must determine which controls are **relevant to the audit**. There is a direct relationship between an entity's objectives and the controls it implements to provide reasonable assurance about their achievement. Many of these controls will relate to financial reporting, operations and compliance, but not all the entity's objectives and controls will be relevant to the auditor's risk assessment.

Step 2 While gaining an understanding of internal controls, the auditor must evaluate the design of the relevant controls, and determine whether the controls are properly implemented.

Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements.

Implementation of a control means that the control exists and that the entity is using it.

Step 3 Having determined which controls are relevant, and are adequately designed to aid in the prevention of material misstatements in the financial statements, the auditor can then decide whether it is more efficient to place reliance on those controls and perform tests of controls in that area, or to perform substantive testing over that area.

Step 4 If the controls are not adequately designed, the auditor needs to perform sufficient substantive testing over that financial statement area in light of the apparent lack of control and increased risk. Any deficiencies are noted and, where appropriate, these will be communicated to management.

ISA 315 (Revised) divides internal control into **five elements:**

- The control environment
- The entity's risk assessment process
- The information system relevant to financial reporting
- Control activities
- Monitoring of controls

3.2 Tests of controls: revision

You will have covered **tests of controls** in your earlier studies. The following section provides a **summary** of the key points.

Testing of controls means obtaining sufficient, appropriate audit evidence about the operating effectiveness of the controls in preventing or detecting and correcting material misstatements.

Evidence will be required to show that:

- controls were applied at relevant times during the year; and

- those controls were applied consistently (eg, because controls were performed by different people or in different locations).

Tests of control may include the following.

(a) **Inspection of documents** supporting controls or events to gain audit evidence that internal controls have operated properly eg, verifying that a transaction has been authorised.

(b) **Enquiries about internal controls** which leave no audit trail eg, determining who actually performs each function, not merely who is supposed to perform it.

(c) **Reperformance of control procedures** eg, reconciliation of bank accounts, to ensure they were correctly performed by the entity.

(d) **Examination of evidence of management views** eg, minutes of management meetings.

(e) Testing of internal controls operating on **computerised systems** or over the overall information technology function eg, access controls.

(f) **Observation of controls** to consider the manner in which the control is being operated.

Auditors should consider the following:

- **How** controls were applied
- The **consistency** with which they were applied during the period
- **By whom** they were applied

Tests of controls are distinguished from substantive procedures which are designed to detect material misstatements in the financial statements.

Deviations in the operation of controls (caused by change of staff etc) may increase control risk and tests of control may need to be modified to confirm effective operation during and after any change.

Audit procedures will include the test of control and then other procedures (eg, substantive and/or analytical procedures) to confirm the operating effectiveness of that control. Overall, audit procedures may be limited where automated processing is involved, as control errors are less likely eg, computers tend to make fewer mistakes than humans after a given procedure has been correctly programmed.

The use of computer-assisted audit techniques (CAATs) is referred to below.

Please also refer back to Chapter 4 for the auditor's responsibilities for the evaluation of internal controls from a corporate governance perspective.

3.2.1 Relationship between tests of controls and risk assessment procedures

Testing of controls should not be confused with risk assessment procedures which were performed earlier in the audit to assess the design and implementation of controls. However, in some situations risk assessment procedures may provide persuasive evidence on the operation of controls. For example, management review of budgets and investigation of variances on a regular basis is indicative that controls over sales and purchases are operating effectively.

3.2.2 Conclude on the achieved level of control risk

When control testing is complete, **residual audit risk** to be obtained from substantive testing **must be determined**. To determine the remaining detection risk the auditor will use:

- The achieved level of control risk; and
- the assessed level of inherent risk.

This detection risk is then used to decide the **nature and timing of the remaining substantive testing**.

Professional skills focus: Applying judgement

Evaluating the outcome of tests of control will require an understanding of the implications for the audit overall. This in turn will require sound skills of judgement.

4 Service organisations

Section overview

Where the auditor's client uses a service organisation, the auditor may need to obtain evidence of the accuracy of processing systems within a service organisation.

Definition

Service organisation: A third-party organisation that provides services to user entities that are part of those entities' information systems relevant to financial reporting.

ISA 402, *Audit Considerations Relating to an Entity Using a Service Organisation* provides guidance on how auditors carry out their responsibility to obtain sufficient, appropriate audit evidence when the audit client (called the 'user entity' in the standard) uses such an organisation.

The ISA mentions the following service organisation services that may be relevant to the audit (this is not an exhaustive list):

- Maintenance of accounting records
- Other finance functions, such as the tax compliance function
- Management of assets
- Undertaking or making arrangements for transactions as agents of the user entity

CHAPTER 7

4.1 Requirements of the user auditor

Definition

User auditor: An auditor who audits and reports on the financial statements of a user entity.

The ISA states that the objective of the auditor is 'to obtain an understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement' (ISA 402.7).

The ISA requires the auditor to understand how the user entity uses the services of the service organisation. In obtaining an understanding of the entity, the auditor shall consider the following:

(a) The **nature of the services** provided by the service organisation

(b) The **nature and materiality** of the transactions processed or accounts or financial accounting processes affected by the service organisation

(c) The degree of **interaction** between the activities of the service organisation and those of the user entity

(d) The **nature of the relationship** between the user entity and the service organisation, including the **contractual terms**

(e) If the service organisation maintains all or part of a user entity's accounting records, whether those arrangements impact the work the auditor performs to fulfil reporting responsibilities in relation to accounting records.

When obtaining an understanding of internal control the auditor shall:

(a) evaluate the design and implementation of controls at the user entity that relate to the services provided by the service organisation; and

(b) determine whether this gives sufficient understanding of the effect of the service organisation on the user entity's internal control to provide a basis for the identification and assessment of risks of material misstatement.

If not then the auditor shall do one or more of the following:

(a) Obtain a report from the service organisation's auditors (there are two different types of report, see below)

(b) Contact the service organisation, through the user entity

(c) Visit the service organisation and perform procedures that will provide information about the relevant controls

(d) Use another auditor to perform procedures that will provide information about the relevant controls

4.2 Using reports from service auditors

Definitions

Type 1 report: A report that comprises both of the following:

- A description, prepared by management of the service organisation, of the service organisation's system, control objectives and related controls that have been designed and implemented as at a specified date
- A report by the service auditor with the objective of conveying reasonable assurance that includes the service auditor's opinion on the description of the service organisation's system, control objectives and related controls and the suitability of the design of the controls to achieve the specified control objectives

Type 2 report: A report that comprises both of the following:

- A description, as in a Type 1 report of the system and controls, of their design and implementation as at a specified date or throughout a specified period and, in some cases, their operating effectiveness throughout a specified period
- A report by the service auditor with the objective of conveying reasonable assurance that includes:

- the service auditor's opinion on the description of the service organisation's system, control objectives and related controls, the suitability of the design of the controls to achieve the specified control objectives, and the operating effectiveness of the controls; and
- a description of the service auditor's tests of the controls and the results thereof.

The availability of a report on internal controls generally depends on whether the provision of such a report is part of the contractual terms between the user entity and the service organisation.

Before placing reliance on the report, the user auditor shall do the following:

- Consider the service auditor's **professional competence and independence** from the service organisation
- Consider the **adequacy of the standards** under which the report was issued
- Evaluate whether the **period covered** is appropriate for the auditor's purposes
- Evaluate the **sufficiency and appropriateness** of the report for the understanding of the internal controls relevant to the audit
- Determine whether the user entity has implemented any **complementary controls** that the service organisation, in the design of its service, has assumed will be implemented

While a Type 1 report may be useful to a user auditor in gaining the required understanding of the accounting and internal control systems, an auditor would not use such reports as a basis for reducing the assessment of control risk.

But a Type 2 report may provide such a basis since tests of control have been performed. If this type of report may be used as evidence to support a lower control risk assessment, a user auditor would have to consider whether the controls tested by the service organisation auditor are relevant to the user's transactions (significant assertions in the client's financial statements) and whether the service organisation auditor's tests of controls and the results are adequate.

4.3 Responding to the risks of material misstatement

The user auditor shall:

- determine whether sufficient, appropriate audit evidence concerning the relevant assertions is available from **records held at the user entity**; and if not
- perform further procedures (or use another auditor to perform those procedures at the service organisation on the user auditor's behalf).

4.3.1 Tests of controls

This evidence can be obtained by one or more of the following procedures:

- Obtaining a Type 2 report, if available
- Performing tests of controls at the service organisation
- Using another auditor to perform tests of controls at the service organisation

4.3.2 Substantive procedures

The following procedures may be considered by the auditor:

- Inspecting documents and records held by the user entity
- Inspecting documents and records held by the service organisation (access to records held by the service organisation may be established as part of the contractual arrangement between the user entity and the service organisation)
- Obtaining confirmation of balances and transactions from the service organisation where the user entity maintains independent records of balances and transactions
- Performing analytical procedures on the records maintained by the user entity or on the reports received from the service organisation
- Where a **significant proportion of the audit evidence** is located at the service organisation, substantive procedures may need to be performed at the service organisation by the user auditor or by another auditor on behalf of the user auditor

4.4 Reporting by the user auditor

4.4.1 Modified opinions

If the user auditor is unable to obtain sufficient, appropriate evidence a modified audit opinion may be required. This could be the case when:

- the user auditor is unable to obtain a sufficient understanding of the services provided by the service organisation and does not have a basis for assessing the risks of material misstatement;
- the user auditor's risk assessment includes an expectation that the controls at the service organisation are operating effectively and the user auditor is unable to obtain sufficient appropriate evidence about the operating effectiveness of these controls; or
- sufficient, appropriate evidence is only available from records held at the service organisation, and the user auditor is unable to obtain direct access to these records.

4.4.2 Reference to the work of service auditors

The user auditor **shall not refer to the work of a service auditor** in the user auditor's report containing an **unmodified opinion** unless required by law or regulation to do so. (If such a reference is required, the user auditor's report must indicate that this does not diminish the user auditor's responsibility for the audit opinion.)

If reference to the work of a service auditor is **relevant to an understanding of a modification** to the user auditor's opinion, the user auditor's report must indicate that this does not diminish the user auditor's responsibility for the audit opinion.

5 Internal controls in an IT environment

Section overview

- IT controls comprise general and application controls. General controls establish a framework of overall control over the system's activities whereas application controls are specific controls over the applications maintained by the system.
- Computer-assisted audit techniques (CAATs) can be used by the auditor to test application controls within the client's computer systems.
- Specific considerations will apply where virtual arrangements including cloud computing are used.

5.1 Introduction

We looked at IT-specific risks in the context of carrying out an audit risk assessment in Chapter 5, and introduced the use of CAATs in Chapter 6. Here, we will consider IT controls in more detail, along with how to audit them.

As you should know by now, the internal control activities in a computerised environment fall within two categories: **general controls** and **application controls**.

5.2 General controls

The purpose of general IT controls is to establish a **framework of overall control** over the computer information system's activities to provide a reasonable level of assurance that the overall objectives of internal controls are achieved. They include controls over access security, data centre and network operations, software acquisition, change and maintenance, and application system acquisition, development and maintenance. They are sometimes referred to as supervisory, management or information technology controls. General controls are considered in detail below.

General controls	
Development of computer applications	Standards over systems design, programming and documentation Full testing procedures using test data Approval by computer users and management Segregation of duties so that those responsible for design are not responsible for testing Installation procedures so that data is not corrupted in transition Training of staff in new procedures and availability of adequate documentation
Prevention or detection of unauthorised changes to programs	Segregation of duties Full records of program changes Password protection of programs so that access is limited to computer operations staff Restricted access to central computer by locked doors, keypads Maintenance of program logs Virus checks on software: use of anti-virus software and policy prohibiting use of non-authorised programs or files Back-up copies of programs being taken and stored in other locations Control copies of programs being preserved and regularly compared with actual programs Stricter controls over certain programs (utility programs) by use of read-only memory
Testing and documentation of program changes	Complete testing procedures Documentation standards Approval of changes by computer users and management Training of staff using programs
Controls to prevent wrong programs or files being used	Operation controls over programs Libraries of programs Proper job scheduling
Controls to prevent unauthorised amendments to data files	Physical security over remote terminals Limited access to authorised personnel only Firewalls User identification controls such as passwords Encryption of data
Controls to ensure continuity of operation	Storing extra copies of programs and data files offsite Protection of equipment against fire and other hazards Back-up power sources Emergency procedures Disaster recovery procedures eg, availability of back-up computer facilities Maintenance agreements and insurance

The auditors will wish to test some or all of the above general controls, having considered how they affect the computer applications significant to the audit.

General IT controls that relate to some or all applications are usually interdependent controls, ie, their operation is often essential to the effectiveness of application controls. As application controls may be useless when general controls are ineffective, it will be more efficient to review the design of general IT controls first, before reviewing the application controls.

General IT controls may have a pervasive effect on the processing of transactions in application systems. If these general controls are not effective, there may be a risk that misstatements occur and go undetected in the application systems. Although deficiencies in general IT controls may preclude testing certain IT application controls, it is possible that **manual procedures** exercised by users may provide effective control at the application level.

5.3 Application controls

The purpose of application controls is to establish **specific control procedures over the accounting applications** in order to provide reasonable assurance that all transactions are authorised and recorded, and are processed completely, accurately and on a timely basis. Application controls include data capture controls, data validation controls, processing controls, output controls and error controls. Examples of application controls are shown in the table below.

Application controls	
Controls over input: completeness	Manual or programmed agreement of control totals Document counts One for one checking of processed output to source documents Programmed matching of input to an expected input control file Procedures over resubmission of rejected items
Controls over input: accuracy	Programs to check data fields (for example value, reference number, date) on input transactions for plausibility Digit verification (eg, reference numbers are as expected) • Reasonableness test (eg, sales tax to total value) • Existence checks (eg, customer name) • Character checks (no unexpected characters used in reference) • Necessary information (no transaction passed with gaps) • Permitted range (no transaction processed over a certain value) Manual scrutiny of output and reconciliation to source Agreement of control totals (manual/programmed)
Controls over input: authorisation	Manual checks to ensure information input is: • authorised; and • input by authorised personnel.
Controls over processing	Similar controls to input must be in place when input is completed, for example, batch reconciliations Screen warnings can prevent people logging out before processing is complete

Controls over master files and standing data	One to one checking Cyclical reviews of all master files and standing data Record counts (number of documents processed) and hash totals (for example, the total of all the payroll numbers) used when master files are used to ensure no deletions Controls over the deletion of accounts that have no current balance

Control over input, processing, data files and output may be carried out by IT personnel, users of the system, a separate control group and may be programmed into application software.

5.4 The use of CAATs

Computer-assisted audit techniques (CAATs) can assist the auditor in testing **application controls**. As you will know from your earlier audit studies, there are generally two types of CAATs: **audit software** and **test data**.

Audit software includes **generalised audit software** and **custom audit software**. Generalised audit software includes programs that allow the auditor to carry out tests on computer files and databases. An example of a generalised audit software program is ACL.

Generalised audit software allows auditors to perform a number of functions, such as database access, sample selection, arithmetic functions, statistical analyses and report generation.

The advantages of generalised audit software include the fact that it is easy to use, limited IT programming skills are needed, the time required to develop the application is relatively short, and entire populations can be examined, thus negating the need for sampling. However, the drawbacks of using this type of CAAT are that it involves auditing **after the client has processed the data** rather than while the data is being processed, and it is limited to procedures that can be performed on data that is available electronically.

Custom audit software is normally **written by auditors for specific audit tasks**. It is normally used in situations where the client's computer system is not compatible with the auditor's generalised audit software or where the auditor wants to do some testing that might not be possible with the generalised audit software. However, this type of CAAT can be **expensive and time consuming** to develop and may require a lot of modification if the client changes its accounting application programs.

Test data is used to test the **application controls in the client's computer programs**. Test data is first created for processing and it includes both valid and invalid data which is processed on the client's computer and application programs. The invalid data should therefore be highlighted as errors. Test data allows the auditor to check data validation controls and error detection routines, processing logic controls, arithmetic calculations and the inclusion of transactions in records and files.

The main benefit of test data is that it provides **direct evidence** on the effectiveness of controls in the client's application programs. However, its drawbacks include the fact that it is very time consuming to create the test data, the auditor cannot be certain that all relevant controls are tested and the auditor must make sure that **all valid test data is removed from the client's systems**.

In the table below, we briefly examine ways of testing application controls, including the use of CAATs to do so.

Testing of application controls	
Manual controls exercised by the user	If manual controls exercised by the user of the application system are capable of providing reasonable assurance that the system's output is complete, accurate and authorised, the auditors may decide to limit tests of control to these manual controls.
Controls over system output	If, in addition to manual controls exercised by the user, the controls to be tested use information produced by the computer or are contained within computer programs, such controls may be tested by examining the system's output using either manual procedures or CAATs. Such output may be in the form of magnetic media, microfilm or printouts. Alternatively, the auditor may test the control by performing it with the use of CAATs.
Programmed control procedures	In the case of certain computer systems, the auditor may find that it is not possible or, in some cases, not practical to test controls by examining only user controls or the system's output. The auditor may consider performing tests of control by using CAATs, such as test data, reprocessing transaction data and, in unusual situations, examining the coding of the application program.

5.5 Virtual arrangements and cloud computing

Where an audit client uses virtual arrangements and/or cloud computing there are a number of specific risks and control issues which the auditor needs to address. The ICAEW Information Technology Faculty document *Cloud Adoption: Understanding the Risk of Cloud Services* is a guide for small businesses considering the adoption of a cloud-based strategy, however many of the issues it raises would also be relevant to the auditor when appraising an entity's system. The following questions would be relevant as part of this process:

Back-ups

- Does the cloud service take regular back-ups of client data?
- Does the client have its own back-up strategy?
- Is the cloud service's process for restoring data regularly tested?
- Is there a service level agreement regarding data assurance and does the cloud service perform exercises to ensure that these can be met?

Security

- Is the platform regularly given to third-party 'penetration testers' for potential vulnerabilities, who vigorously test the platform to determine whether an attacker could gain unauthorised access?
- Is there an adequate process in place in the event of a security breach being determined?
- Is data held on the platform stored in an encrypted format?
- Is payment data held on a PCI-DSS compliant platform?
- Are there recognised, standard working processes and procedures in place and adopted (eg, are ISO accreditations held)?
- Is the platform protected against 'denial of service' attacks, where attackers could prevent access to the service indefinitely by flooding the platform with erroneous traffic or requests for information?

Compensation for loss

- Are compensation levels for loss of data written into agreements?

Using the service

- Are there contractual commitments regarding availability of service and performance levels?
- What is the provider's capability to develop new features ie, is there a realistic roadmap?
- To what extent are features integrated?
- Are responsibilities for ongoing support documented?

Professional skills focus: Assimilating and using information

Being able to differentiate between general and application controls will allow the auditor to assess a system and how robust it is. This demonstrates the ability to assimilate information about the system for the purpose of evaluating the system.

6 Cyber security and corporate data security

Section overview

Businesses need to keep their data secure whether it is in hard copy or electronic format. As business operations increasingly use digital technology the issue of cyber security is an essential consideration as part of the audit.

6.1 Introduction

There has always been a need for companies to keep information, or data, safe. This might be to ensure confidentiality of customer details, to protect company 'secrets' or to ensure the integrity of data. Where records and data are held in a hard copy format, as would have been the case in the past, data security centres around physical security. This might simply involve a lock on a filing cabinet. Increasingly, however, data is stored electronically. As a result, if a business is to keep its data secure it must address the issue of cyber security. Addressing cyber security threats will be a key part of its corporate data security strategy.

6.2 Nature and consequences of cyber threats

One of the key issues which is transforming the current IT risk landscape is cyber security. As companies are increasingly involved in digital technology, mobile technology and cloud computing so the associated risks have also increased. Potential threats may arise from a number of sources. The Deloitte publication *Cybersecurity: The Changing Role of the Audit Committee and Internal Audit* identifies these as follows:

- Cyber criminals
- Hactivists (agenda driven)
- Nation states
- Insiders/partners
- Competitors
- Skilled individual hacker

It also identifies the following risks resulting from an attack:

- Theft of IP/strategic plans
- Financial fraud
- Reputational damage
- Business disruption
- Destruction of critical infrastructure
- Threats to health and safety

(Source: Deloitte (2015) Cybersecurity: The Changing Role of the Audit Committee and Internal Audit. [Online]. Available from: www2.deloitte.com/content/dam/Deloitte/sg/Documents/risk/sea- risk-cyber-security-changing-role-in-audit-noexp.pdf: p.10 [Accessed 27 May 2022])

The ICAEW IT Faculty document, *Audit insights: Cyber Security – Taking Control of the Agenda*, available from: https://www.icaew.com/-/media/corporate/files/technical/audit-and-assurance/audit- insights/audit-insights-cyber-security-2016.ashx [Accessed 27 May 2022], highlights the constantly evolving nature of cyber risks as follows:

- Threats change as attackers get more sophisticated and find new ways of breaking into systems. New attackers also emerge, as easy-to-use tools reduce the level of skill required to carry out attacks.
- Vulnerabilities change as businesses digitally transform their business models and ways of working, potentially creating new weaknesses in business processes eg, mobile ways of working, or adoption of the internet of things.
- Existing controls and assurance models are superseded by new approaches. For example, moving to cloud-based systems has made traditional assurance models around IT controls more difficult to apply.
- The impact of failures increases as businesses capture more data and rely more heavily on digitally-based services. A slow or poor response to a major breach is very quickly and publicly shared over social media, increasing at least short-term reputational damage. In addition there are increasing amounts of regulation, particularly regarding data protection and personal data which companies need to consider. For example, new or forthcoming legislation in the EU includes the following:
- The **General Data Protection Regulation** (**GDPR**): The General Data Protection Regulation (GDPR), enacted by the European Union in May 2018, stands as a benchmark in data protection legislation, influencing numerous countries worldwide. It mandates adherence to core principles including transparency, legality, integrity, confidentiality, accountability, accuracy, and storage limitations. Within the GDPR, data is classified into various categories such as physical, physiological, mental, genetic, economic, social, and cultural. Personal data, defined as information capable of identifying an individual, necessitates the maintenance of processing records to demonstrate compliance.

In the UK, the GDPR came into force on 25 May 2018, bringing it in line with the rest of the EU where similar legislation already exists. The GDPR updates and replaces the existing regulatory framework around the protection and use of personal data (see section 6.2.1 below for an overview of this legislation).

Despite sporadic provisions in legislations like the Digital Security Act, ICT Act, Telecommunications Act, and Article 43 of the Constitution of Bangladesh, a comprehensive data protection regime is yet to materialize in Bangladesh. Nonetheless, efforts towards establishing such a framework are underway, albeit in the nascent stages, with no set date for its enactment.

- In the UK, the **Network Information Security** (**NIS**) directive, which specifies obligations regarding cyber security in certain industry sectors, largely associated with the critical national infrastructure and major information processing activities

In June 2014 the Bank of England announced a new framework for cyber-security testing in the financial services sector and the Information Commissioner is becoming more proactive in examining the privacy policies of major technology companies such as Facebook.

The Bangladesh Bank also issued Guideline on ICT Security for Banks and Non-Bank Financial Institutions in May 2015.

(Source: ICAEW IT Faculty document: Audit insights: Cyber Security – Taking Control of the Agenda: p.7)

The number of high profile cases of breaches which have been reported in the press demonstrates the challenging environment in which companies now operate. For example in 2014 a breach of Apple's iCloud resulted in the publication of the private photos of celebrities. In August 2015 hackers stole and published details related to more than 30 million individuals registered with the Ashley Madison online dating website resulting in class suit actions against the company.

(Source: ICAEW IT Faculty document: Audit insights: Cyber Security – Closing the Cyber Gap: p.4)

6.2.1 GDPR UK

The following table summarises the key points that are relevant to all accountants in UK in this area.

GDPR components	Implications in practice for accountants
Organisations must only collect **personal data** (including **sensitive personal data**, such as biometric data used to identify an individual) when it can demonstrate that it has a **valid business need** for that data. The GDPR distinguishes between data **controllers** who specify how and why data is processed and data **processors** who act on the controller's behalf and deal directly with data itself. Both are liable under the GDPR.	Data can only be obtained for a **legitimate business need** and cannot be collected in case it might be useful at some stage in the future. This means that accountants need to consider carefully what data they really need and be able to justify it: • This includes data on employees, customers and suppliers for all accountants and firms • For firms, this also includes the details of any testing completed (eg, payroll and supplier statements)
Personal data must be **stored** securely. It must then be **deleted** when it is no longer required.	This can include both **physical** storage of data (eg, in filing cabinets) and **electronic** storage – given the vast amounts of data generated in the 21st Century due to advances in technology such as big data and audit data analytics, this creates a significant risk for all accountants, especially as many organisations now use 'cloud-based' data storage.
All organisations need to **demonstrate** how they have **complied** with the GDPR – essentially this means accountability and transparency of all data usage.	**Non-compliance** is obviously a significant issue for all accountants, given the potential size of the fines that could be levied.

<table>
<tr><th>GDPR components</th><th>Implications in practice for accountants</th></tr>
<tr><td> Governance protocols require the completion of a Data Protection Impact Assessment (DPIA) in situations when risk is enhanced (such as when using new technology or when processing might lead to a high risk to individuals). Breaches in the GDPR also need to be disclosed – fines for non-compliance can reach either €20 million or 4% of an organisation's global turnover. </td><td>Being able to demonstrate compliance requires an understanding of the original purpose for collecting such data to ensure that it is lawful and that consent was obtained from individuals before any personal data is collected.</td></tr>
<tr><td colspan="2"> The GDPR confers a series of rights on anyone whose personal data may be collected by an organisation: The right to be informed (usually via some form of privacy notice)
The right of access to your personal data and confirmation that it is being used
The right of rectification if errors exist
The right of erasure (sometimes referred to as 'the right to be forgotten')
The right to restrict processing should you not wish your data to be used
The right to data portability across different services should you wish
The right to object (for example if you object to your data being used for marketing purposes)
Rights in relation to automated decision-making and profiling (essentially, to ensure that all decisions about your data are made using human not machine judgement) Any non-compliance in relation to any of these rights may lead to fines and penalties, so they should form part of any DPIA carried out. </td></tr>
</table>

(Source: The Information Commissioner's Office (ICO) (2017) *Overview of the General Data Protection Regulation (GDPR*). Available online: https://ico.org.uk/media/for-organisations/data- protection-reform/overview-of-the-gdpr-1-13.pdf [Accessed 27 May 2022].)

Context example: BA and Marriott Hotels

In July 2019, the UK Information Commissioner's Office imposed fines on British Airways (BA) and the Marriott Hotel chain of £183 million and £99 million respectively in relation to data breaches.

Previously, the largest UK penalty for this offence was £500,000 imposed on Facebook in relation to its involvement in the Cambridge Analytica scandal in 2014. The reason for such a drastic increase in these penalties is the fact that the GDPR is now in force. Clearly, this new legislation is designed to remind organisations of the responsibilities they bear when dealing with other people's data, despite claims from both companies that external entities were the source of the breach in each case.

(Sources: BBC News Website (2019) British Airways faces record £183m fine for data breach (Available online) https://www.bbc.co.uk/news/business-48905907 [Accessed 27 May 2022]; BBC News Website (2019) UK Watchdog plans to fine Marriott £99m (Available online). https://www.bbc.co.uk/news/technology-48928163 [Accessed 27 May 2022])

6.3 Corporate governance and cyber security

6.3.1 Board of directors

Although there is no specific guidance as such (eg, in Corporate Governance Codes) the ultimate responsibility for risk assessment and control, from whatever source lies with the board of directors. In larger organisations responsibility for cyber security may lie specifically with the chief information security officer (CISO). In many smaller organisations it may be the CEO or a chief risk officer.

6.3.2 Audit committee

As the Deloitte publication *Cybersecurity: The Changing Role of the Audit Committee and Internal Audit* explains, the audit committee may perform a useful role in "overseeing risk management activities and monitoring management's policies and procedures" (Deloitte, p.5).

Responsibilities might include:

- setting expectations and accountability for management;
- assessing the adequacy of resources; and
- liaising with other groups in enforcing and communicating expectations regarding security and risk.

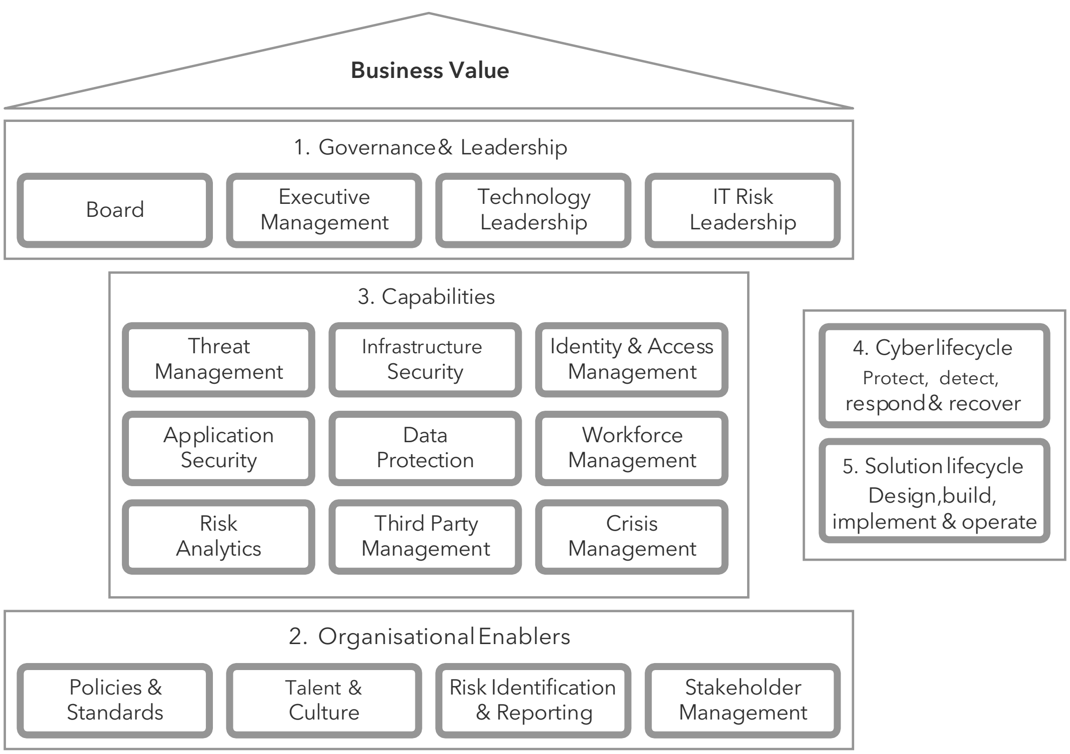
6.3.3 Internal audit function

The internal audit function can aid in the identification of the company's strengths and weaknesses. It can evaluate whether there is effective cyber risk management and also evaluate and review cyber security related controls.

6.4 Cyber risk management

The Deloitte publication suggests that organisations adopt the following 'Framework for Cyber Risk Management'.

Figure 7.1: Framework for cyber risk management



CHAPTER 7

The five functions (governance and leadership, organisational enablers, capabilities, cyber lifecycle and solution lifecycle) provide a 'strategic view of an organisation's management of cyber security risks'.

The ICAEW IT Faculty document, *Audit insights: Cyber Security – Taking Control of the Agenda* refers to the 'three lines of defence' model. This applies controls, assurance and oversight at three different levels in the organisation as follows:

- The first line is at an operational level, with controls built into processes and local management responsible for their operation in practice ie, identifying and managing risks on a day-to-day basis.
- The second line is at functional specialism level, for example the role of cyber-security specialists and a chief information officer ie, providing oversight and expertise.
- The third line is at the level of internal audit functions or independent assurance providers ie, providing assurance and challenge concerning the overall management of the risks.

6.5 Risks external to the entity

As identified in the ICAEW IT Faculty document: *Audit insights: Cyber Security – Closing the Cyber Gap* the issue is becoming an increasingly relevant aspect of supply chain risk management as many high profile security breaches have come as a result of issues at suppliers, including IT service providers, suppliers of non-IT goods and services and contractors. Obtaining assurance in this respect is not an easy process meaning that companies are having to identify where the biggest risk lies rather than simply focusing on the highest value suppliers. In addition, companies have had to consider widening the scope of assurance processes so that they apply to all stages of the transaction, rather than just at the procurement stage as has historically been the case. The most common method used, particularly by large companies, is questionnaires which are sent to suppliers to enable their processes to be evaluated and risks identified.

6.6 Cyber security economics

Implementing effective cyber security measures is expensive and boards need to be able to justify the level of expenditure to their shareholders. This can be difficult particularly in an environment where increased investment does not appear to prevent breaches. In the past costs have been measured against the benefits of reduced losses caused by these breaches. However as this issue has risen up the board agenda companies are beginning to view the benefits of this expenditure in a different context. As identified in the ICAEW IT Faculty document: *Audit insights: Cyber Security – Closing the Cyber Gap* these could include:

- a brand enhanced by the strong security culture;
- the ability to bid for contracts in a particular supply chain; and
- reduced insurance premiums.

6.7 Audit implications

As with any risk which a business faces the auditor must understand and evaluate the risk together with the effectiveness of associated controls. In relation to cyber security the auditor will need to pay particular attention to the control environment and specific control procedures put in place by management.

6.7.1 Control environment

The following features would be an indication to the auditor that the control environment in respect of cyber security is strong:

- Responsibility for cyber security elevated to board level, preferably to a designated individual eg, a risk officer

- Evidence of active board oversight, including clear lines of responsibility and identification of key business data and associated risks
- Cyber security policies and procedures embedded in operations and monitored for effectiveness
- Evaluation of the entity's risk appetite and procedures to highlight risks which breach this level
- Non-executive directors and audit committee members with appropriate skills and training to understand the issues
- Recruitment of competent in-house professionals with relevant expertise and/or use of consultants
- Encouragement of communication between IT specialists and the board, internal auditors and the audit committee
- Creation of an environment where staff are comfortable to report concerns and/or actual instances of breaches of security without fear of reprisals

The ICAEW IT Faculty document, *Audit insights: Cyber Security – Taking Control of the Agenda* includes a series of checklists for boards. Whilst these take the perspective of the business they provide an indication of what would constitute a strong control environment and the factors which the auditor should consider when evaluating the control environment.

Checklist for boards	**Considerations for the auditor**
Be ready to respond	Consider the most serious possible breach and ask whether the organisation, and board, are ready to cope. What would they do if competitors accessed their IP? How does the business reassure customers if their data is stolen?
Build intelligence	What does the business know about specific threats, the actors and their possible methods? How have other major breaches happened, and how do the defences put in place by the business compare? What are their peers doing to manage their risk? How can they get ahead of the regulators?
Be specific and real	How can critical data actually be accessed and by whom? What controls are in place, and how does the business know whether they are working? How are any breaches detected?
Link to strategic change	How are major strategic initiatives changing the risks? What is the impact of any M&A activity? What are the risks attached to new products or market expansion?
Attach consequences	What behaviour is unacceptable because of cyber risks? How does the business know if non-compliance is occurring? What happens to employees who do not follow the rules?
Tailor activities	How relevant is cyber security training to specific roles and responsibilities? Do higher-risk jobs have higher levels of training and awareness-raising activities? Are staff clear about the purpose of good cyber behaviour?
Hold boards to the same level of accountability	Are boards expected to follow the same rules as staff? Is the board clear as to the purpose and consequences of non-compliance? Does the board see itself as a role model for good cyber behaviour? Do members of the board act as role models?
Remember insider risk	What is in place to detect suspicious behaviour or patterns? How are disgruntled or disaffected staff identified? Does the business know how much system access potentially disaffected staff have?

Checklist for boards	Considerations for the auditor
Implement cyber-by-design	Are new products and services designed with cyber risks in mind? Do business change projects consider cyber risk early on? What are the risks of poor design?
Continually review and re- evaluate	Are designs building in flexibility and resilience to cope with changing cyber risks? How often are cyber risks reviewed? How are changing risks incorporated into existing processes?
Take difficult decisions	Is the business prepared to delay major change or strategic projects if the security is not good enough? Is the business using a 'sticking plaster' approach to an old infrastructure?
Embed cyber into start-ups	If investing in new businesses, are cyber risks considered?

6.7.2 Control procedures

The auditor would also need to identify and evaluate the effectiveness of specific control procedures. This work is likely to involve the IT audit specialists.

The Deloitte publication *Cybersecurity: The Changing Role of the Audit Committee and Internal Audit* identifies that in order to be effective cyber defence needs to be:

- Secure: Are controls in place to guard against known and emerging threats?
- Vigilant: Can the company detect malicious or unauthorised activity, including the unknown?
- Resilient: Can we act and recover quickly to reduce impact?

Specific procedures to address these issues could include the following:

- Perimeter defences
- Vulnerability management
- Asset management
- Identity management
- Data protection procedures
- Threat intelligence eg, sharing intelligence with others within the same industry
- Security monitoring
- Behavioural analysis
- Risk analytics
- Incident response procedures
- Forensics
- Business continuity/disaster recovery procedures
- Crisis management

Professional skills focus: Structuring problems and solutions

An awareness of both the control environment and control procedures should help an auditor assess the impact of any cyber threats. This is an example of structuring a problem to achieve an effective solution.

Interactive question 1: NewForm Ltd

NewForm Ltd (NewForm), a client of your firm, has recently established an e-commerce division within its existing business to provide an additional outlet for its product range, which consists of upmarket casual wear for adults. An objective in introducing the new division was to have a completely paperless ordering, payment and despatch system.

The new e-commerce system is administered centrally by NewForm and deals with customer orders and credit card payments. Customers are able to place orders and pay for the goods online.

Inventories for customer orders are held remotely by Key Distributors (KD), which is a completely separate business from NewForm. Once online payment by credit card is cleared by NewForm, despatch details are forwarded to KD electronically. KD then despatches customer orders.

Inventories are ordered by NewForm for delivery direct to KD.

Requirements

1.1 In planning the audit of NewForm, identify and explain four key audit risks that may arise from the development of the new e-commerce division.

1.2 Identify and explain the application controls which you think are necessary for the integrity of the ordering and payments system.

See **Answer** at the end of this chapter.

7 Communicating and reporting on internal control

Section overview

Auditors are required to report to those charged with governance on material deficiencies in controls which could adversely affect the entity's ability to record, process, summarise and report financial data potentially causing material misstatements in the financial statements.

The specific responsibilities of the auditor in relation to communicating deficiencies in internal control are set out in ISA 265, *Communicating Deficiencies in Internal Control to Those Charged With Governance and Management*. The auditor is required to report significant deficiencies in internal controls, where they have been identified, to those charged with governance and management (already covered in Chapter 4).

Definitions

Deficiency: A deficiency in internal control exists when:

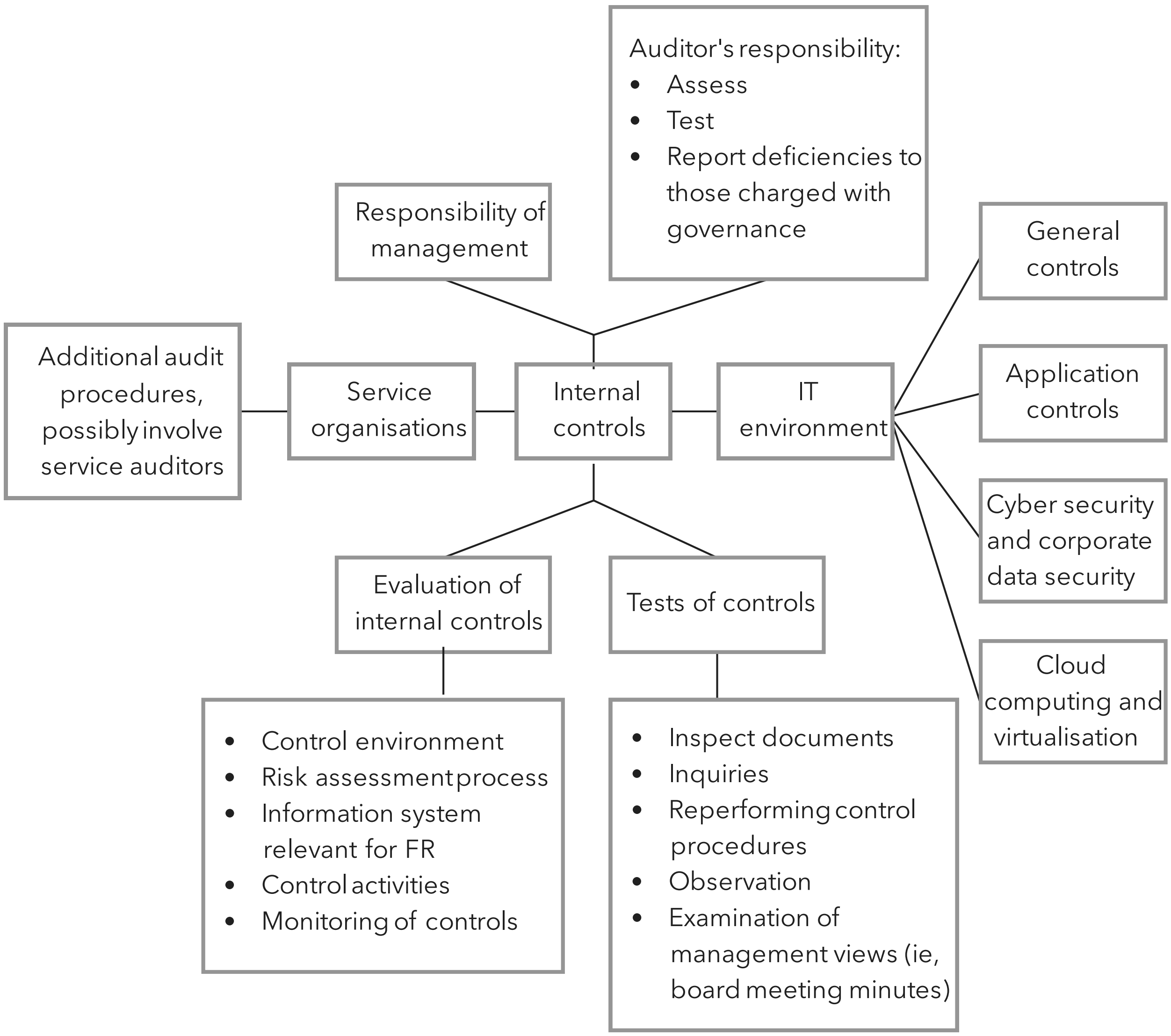
- a control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or
- a control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

Significant deficiency in internal control: Those which in the auditor's professional judgement are of sufficient importance to merit the attention of those charged with governance.

Professional skills focus: Concluding, recommending and communicating

The process of reporting to those charged with governance on material deficiencies in internal control requires strong communication skills as well as the ability to conclude that the deficiency might be significant.

Summary


Auditor's responsibility:
• Assess
• Test
• Report deficiencies to those charged with governance
Responsibility of management
General controls
Additional audit procedures, possibly involve service auditors
Service organisations
Internal controls
IT environment
Application controls
Cyber security and corporate data security
Evaluation of internal controls
Tests of controls
Cloud computing and virtualisation
• Control environment
• Risk assessment process
• Information system relevant for FR
• Control activities
• Monitoring of controls
• Inspect documents
• Inquiries
• Reperforming control procedures
• Observation
• Examination of management views (ie, board meeting minutes)

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Can you explain the importance of internal controls as part of the auditor's role?
2.	Can you distinguish between the relative responsibilities of those charged with governance and the auditor?
3.	Can you explain how the auditor evaluates internal controls and recommend suitable tests of control to support the audit opinion?
4.	Can you explain the impact on the audit of an entity choosing to outsource some of its core functions? What factors will this impact be dependent on?
5.	Do you know the difference between general and application controls in an IT context? Are you aware of the impact that new technology such as cloud computing can have on the audit?
6.	Can you explain the various cyber threats that an organisation is at risk from and how such cyber threats are mitigated?
7.	How should the auditor communicate deficiencies in internal control and what makes such a deficiency significant?

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Dodgy Burgers plc	Being able to consider suitable audit procedures for testing relevant internal controls.
Happy Flights plc	This question tests how well you can discuss cyber security issues in the context of a broader audit engagement.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios that will help you improve your knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
UHN requirement (4)	You need to be able to explain the board's responsibilities and accountability for cyber security.
Newpenny requirement (2)	You should be able to evaluate Rosa's suggestion of placing more reliance on operating effectiveness of controls.
Johnson Telecom requirement (3)	As part of the key risks from derivatives trading, you need to consider the necessary general and application IT controls that would be required.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving on to the next chapter.

Technical reference

1 ISA 315

- Risk assessment procedures – **ISA 315.13–.18**
- Understanding the entity and its environment – **ISA 315.19–.27**
- Assessing the risks of material misstatement – **ISA 315.28–.37**
- Financial statement assertions – **ISA 315.A190**
- Documentation – **ISA 315.32**

2 ISA 330

- Overall responses to risk assessment – **ISA 330.5**
- Response at assertion level – **ISA 330.6–.7**
- Evaluation of sufficiency and appropriateness of evidence – **ISA 330.25–.27**

Self-test questions

Answer the following questions.

1 Dodgy Burgers plc

The board of directors of your client, Dodgy Burgers plc, which runs a chain of 30 burger restaurants across the country, has just completed a review of the structure of the business and relevant controls which are in place within the business. This review was completed in the year ended 31 March 20X8.

A partner of your firm asked for a copy of the report that the directors completed to assist in the identification of controls that the directors had implemented to mitigate business risk. The partner would like to use this as a basis for testing and placing reliance on these controls to reduce the amount of audit work undertaken for the audit for the year ended 31 March 20X8.

Listed below are some extracts from the report.

Health and safety issues

The following systems have now been introduced.

(1) The new internal audit department set up in September 20X7 will make spot checks on the various shops to ensure that the new Health and Safety policies are being followed. Reports of these visits will be sent to the board within two weeks of the visit. The internal audit department plans to visit all the branches within one year.

(2) All staff will receive Health and Safety training, particularly on the areas of food handling, storage, preparation, cooking and hygiene. This will be implemented immediately and by the end of 20X8 we will have trained all staff.

Competition

Our main competitor, Chip Butty, has begun buying properties and setting up shops in the vicinity of our existing branches within the large city centres. This has been a recurrent theme through 20X8 so far and we expect this to continue into 20X9. We have identified this as a threat to our sales income and consider that action is required.

To counteract the potential loss in sales we have embarked on three new marketing initiatives.

(1) Advertising on all major local television networks, comparing our burgers to the inferior Chip Butty products

(2) Promoting our new toys, sold in conjunction with Dotty Films, which are free with all kiddy packs

(3) Employing a part-time member of staff to visit the competition's premises and reporting on any new initiatives Chip Butty embarks upon

Branch cash controls

As our business is primarily cash based, we were concerned over the potential for theft of cash takings.

We have decided to implement a new policy in this area to monitor the takings from each branch more closely.

All tills in every branch will include a standard float of £150. At the end of each day the takings will be counted and bagged from each till, leaving the £150 float. A printout from the till will be made detailing the daily takings. The physical cash will need to be reconciled to the till balance. Cash will then be banked and the reconciliation emailed to head office.

Discount prices will be set in the till to ensure that no meals can be sold at below the discounted price.

Increased turnaround in branches

We have identified a capacity problem in our branches, given the limited seating area at each of the branches during peak times.

Following a cost-benefit review of the branches it was decided not to increase these areas, as we feel that it would not be cost effective due to the huge increase in rates that would be incurred, the building costs and lost time due to renovation.

The board is prepared to accept the risk that some customers may be lost during peak times, but may in the future consider some form of takeaway discount at peak times.

Environmental policy

We felt it was necessary to reassure the public that as a company our policies are 'environmentally friendly' as this was key to a consumer business such as ours. The increased cost of the packaging products has been passed on in full via a small price increase, as we have been able to negotiate an excellent package with our suppliers and the waste contractors.

We have therefore introduced the following.

(1) Recycled packaging in all our branches, which has been clearly labelled to show that it is made from paper used from managed forests

(2) Waste separation at branches, which is collected on a daily basis by an external contractor who pays us £30 for each ton of paper and plastic collected

Requirement

Answer the following questions:

(1) Identify the business risks set out in the board report and state the risk category (ie, financial, operational or compliance). For each risk identified state the strategy management have adopted to deal with the risk.

(2) For each of the risks identified set out the audit procedures that would need to be completed before reliance could be placed on the controls in place.

2 Happy Flights plc

Happy Flights plc (HF), a listed company is a low-cost airline that was established 15 years ago and has since grown rapidly. You are a senior on the audit of HF for its year ended 30 June 20X6.

As part of the audit planning procedures the assignment manager, Geraint Johns, visited the finance director of HF, Rory Hiller, and identified a number of risk areas (**Exhibit 1**).

Geraint rang you immediately after the meeting:

I have just been to visit HF and there are a number of issues that have arisen. The audit team needs to discuss these matters at a planning meeting so we can determine our approach. I would like you to prepare a memorandum for the meeting which explains in detail the key audit risks including any cyber-security related issues, arising from these matters. I would also like you to identify the audit procedures that we will need to carry out in respect of each of these risks. If there are any financial reporting issues on these matters could you also explain these as part of the memorandum.

Requirement

Prepare the memorandum requested by the assignment manager.

Exhibit: Risk areas Plane crash

You will be aware that on 20 June 20X6 one of the HF planes crashed with a loss of 56 lives and a further 121 injuries. The cause of the crash has not yet been established. Indeed, it is unclear whether HF is to blame. Some legal claims have begun to arrive at HF headquarters but it is still early in the investigation process. Final settlement, if applicable, may take some years.

Operating issues

HF has suffered declining profits in recent years and recorded an operating loss for the first time in the year to 30 June 20X5.

As a consequence, there have been continuing cash flow problems which have been partially alleviated by special measures adopted this year, including:

- significant discounts for bookings made, and paid for in full, at least six months before travel;
- extension of short-term leases on existing aircraft, rather than leasing new aircraft (all planes are leased); and
- significant new fixed-term borrowings.

Database system

A new database system for bookings was introduced in January 20X4 by IT consultants. The purpose of the new system was to allow data on HF's flight availability to be accessed by travel agents and other flight booking agencies around the world. Agencies can all make bookings on the same system.

The database system is used not just for bookings but also as part of the receivables accounting system for agents to collect money from customers and pay to HF after deducting their commission. The data collected then feeds into the financial statements.

Unfortunately, since installation, the following problems have been discovered, either in the database system, or relating to operatives using the system:

- It is HF's policy to overbook its flights by 5% of seat capacity. However, there have been a number of instances where overbookings have far exceeded 5% due to processing delays.
- The system has crashed on a number of occasions causing delays in processing and loss of data.
- A computer virus penetrated the system, although it did not cause any damage and was quickly removed.
- Cash received in advance has been recorded as revenue at the date of receipt by HF.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

1.1 Key risks from the development of the e-commerce division

There are a number of concerns that an auditor of NewForm should address in relation to its new e-commerce division. However, the general rule is that the scale of risk that is related to e-commerce is directly proportional to the number of users and the value of their transactions, which is critical to NewForm's proposal. The key areas are likely to be as follows.

- Consider what cyber security issues have been addressed by the company. For example, there may be difficulties with ensuring the integrity of the payments system and protecting customer data (including bank details) from hackers, which will result in an increased focus on revenue from online sales.
- Cyber attacks could also lead to disruption or suspension of the e-commerce platform resulting in loss of sales and reputational damage.
- There may be breaches of data protection regulations regarding customer details resulting from fraud (eg, cyber attacks) or poor procedures. This could result in the company being exposed to litigation and fines, which may require provisions in the financial statements.
- Consider what additional inventory control measures have been implemented. Inventories are presumably fairly high value, and hence will be material to NewForm's activities. What measures have been implemented to track customer orders? What procedures have been put in place to deal with returned goods in relation to checking claims relating to returned goods and authorisation/processing of refunds? This may be a particular difficulty, given the remote nature of the shipment of goods.
- Assess if NewForm has the technical skills to develop and support a new e-commerce division of the type proposed.
- Evaluate if consideration has been given to ensuring the continuity of operations, given the increasing reliance of the business on technology. Specific issues include:
  - Lack of resources may undermine effective contingency plans; this may force a business to accept a higher tolerance of errors in the system, thus leading to a deeper inherent risk within the organisation
  - Inadequate controls surrounding the interaction of e-commerce applications with other business critical applications
  - Undermining of otherwise effective controls, eg, from inadequate recognition and use of controls, combined with inadequate monitoring of control compliance
- Inventories are held remotely, and thus control over a significant asset is exercised largely by a third party.
- Online ordering creates problems of security and data protection.
- Lack of audit trail in a paperless system.
- Dependence on a sole distributor.

1.2 Application controls

A number of application controls may be relevant, for example the following:

- Pre-processing authorisation
  - Customer password systems
  - Credit payment authorisation
  - Customer account balance limit tests
- Validation tests
  - Consistency with previous orders in terms of value

Answers to Self-test questions

1 Dodgy Burgers plc

Risk/Audit procedure

(1) Business risk and category	Management strategy to combat risk	(2) Audit procedures to be completed in order to place reliance on the controls in place
Health and safety		
• Partially cooked burgers have been sold. • This constitutes an operational risk (failure to comply will result in the company being shut down) and compliance risk (breach of Health and Safety regulations).	• Management has set up a Health and Safety training programme.	• Obtain a copy of the Health and Safety policy and review to ensure that the policies are adequate. File on the permanent audit file for future reference. • Hold discussions with the branch managers on a sample basis to ensure that the policy has been implemented if staff do not reach the required standard. • Review the training course to establish what procedures are being taught to the staff, and what follow up has been implemented if staff do not reach the required standard.
	• Internal audit spot checks on Health and Safety are to be carried out at the branches.	• Assess the internal audit department staff to ensure they have the appropriate authority, and are technically competent to complete the review. • Discuss with the internal audit department how the branches have been selected for sampling. • Review copies of the internal audit reports to identify: - the issues found; - how they have been resolved; - what follow-up work was required; and - how this was monitored.

CHAPTER 7

(1) Business risk and category	Management strategy to combat risk	(2) Audit procedures to be completed in order to place reliance on the controls in place
		• Discuss with the directors how many visits have been completed in the year and whether they received all the copies of the reports. • Review correspondence files and external Health and Safety visits during the period before the internal audit department was setup. • Provided that the internal visits are effective, audit procedures can be limited to the period before the internal audit department was set up, as this is likely to be the higher audit risk area.
New competitor		
• A new competitor has set up in major cities within the vicinity of Dodgy Burgers plc. • This constitutes an operational risk (could lead to going concern problems and, ultimately, closure). • The instigation of a major advertising campaign itself constitutes a compliance risk (Advertising Standards need to be complied with). • The campaign and promotional gifts lead to financial risk (large cash outlay).	• Advertising campaigns and promotional gifts. • New staff member employed to visit rivals.	• Review gross profit margins to assess if there has been a major impact on sales. • Discuss with the directors and review the national press to identify what impact this competition is likely to have and whether or not they are aiming for the same market. • Review the advertising expenses account to ensure that adverts have been bought and paid for. • Review correspondence from the Advertising Standards Authority to ensure no complaints have been logged as a result of the advert. • Review contracts with the television companies to ensure that primetime slots had been given. • Review sales accounts to establish that sales have increased in the period during or following the advertising campaigns.

(1) Business risk and category	Management strategy to combat risk	(2) Audit procedures to be completed in order to place reliance on the controls in place
		• Review the employment records to ensure that the staff member has been employed on a part-time basis and review the contract/job description. • Review the reports sent to the board to establish if suitable observations have been made and have been acted on.
Cash controls		
• Risk of theft of cash takings (financial risk).	• New controls implemented to set till floats and provide reconciliations to head office on a daily basis.	• Review returns from branches to head office on a sample basis. • Discuss the differences identified with head office staff and review the action taken.
Limited seating		
• Lack of seating in most branches during peak times (operational risk – loss of customers).	• No strategy has been put in place due to cost-benefit considerations but takeaway discount at peak times may be considered in the future.	There is therefore no control as such to rely on but there are potential going concern issues. • Discuss with branch managers the number of customers at peak times, and the level of complaints re the lack of seating area. • Discuss with the directors the impact this may have in the future if competitors are close by to the branches, loss of customer may increase. • Spot check the branches on a sample basis to establish the customers leaving without purchasing to confirm the extent of problem highlighted by the directors.
Recycled products		
• A lack of confidence from the public in Dodgy Burgers plc's environmental policies (operational and compliance risk).	• The use of recycled packaging. • Waste separations and collections.	• Review the contracts with the suppliers to ensure that recycled packages are clearly specified and the price is comparable to the original prices of non-recycled products.

(1) Business risk and category	Management strategy to combat risk	(2) Audit procedures to be completed in order to place reliance on the controls in place
		• Review the branch returns to ensure that delivery notes have been signed for the waste collection and the receipts match the tonnage collected. Ensure that these are in line with expectations from the preliminary analytical procedures on the accounts. • Review the new packaging for evidence that the recycled symbols have been correctly displayed. • Discuss with the branch managers if any further costs have been incurred from having to separate the waste for collection, or whether separate bins have been provided in the branches for the public to use.

2 Happy Flights plc

Memorandum

To Geraint Johns (Assignment Manager)

From A Senior

Date 24 July 20X6

Subject Happy Flights – audit risks

(1) Plane crash

Financial reporting issues

The plane crash occurred in the year to 30 June 20X6, thus potentially gives rise to a liability that might need to be recognised in the current period. This might include:

- civil litigation by those passengers injured and the relations of those killed;
- criminal penalties against HF and/or its directors;
- if health and safety regulations have been breached then further penalties and constraints may apply; or
- liability for employees killed and injured.

Any litigation may be in several jurisdictions according to the location of the crash and the nationality of the passengers, thus the issues may be complex and take some time to resolve.

While such liabilities may ultimately be substantial they may also turn out to be small if the fault lies with airport authorities or other causes. It seems likely that these issues will be unresolved when the financial statements are authorised for issue thus it is unclear whether a contingency or a provision would arise. If there is significant uncertainty, or if there is a low probability of a claim, this might indicate a contingency, but more information would be needed to draw a firmer conclusion (see below).

Audit risks

A key audit risk is the lack of information on which to base a judgement in respect of the following:

- Whether any liability is probable or only possible
- The amount and timing of such a liability is unlikely to be known at the date of audit completion

According to IAS 37 where the amount of an obligation cannot be measured with sufficient reliability then it should be disclosed as a contingent liability. In this case it would not be recognised in the financial statements. If the information available is still fundamentally unclear at the date the financial statements are authorised for issue, then this may be the most appropriate treatment.

If the company is insured then recovery of any insurance should be regarded as a separate matter from the provision/contingency question.

Going concern – Notwithstanding the treatment of the provision/contingency then going concern is likely to be an issue. Given that the company is already struggling financially, any claim may prove to be a significant additional factor in assessing going concern. However, insurance recovery may be considered in making any such assessment.

There may, however, be other more immediate going concern issues arising from the crash other than the settlement of litigation.

These include:

- reduction in passenger numbers, as the reputation for safety may have diminished;
- grounding of aircraft by health and safety regulators perhaps resulting in loss of revenues, cancellations and delays; and
- reconsideration of leasing older planes resulting in additional costs.

Audit procedures

- Review claims against HF received by audit completion.
- Review correspondence with HF's legal advisers and consider taking independent legal advice regarding the amount and probability of any claim against HF.
- Review any announcements by investigation teams and any correspondence with HF regarding causes of the crash and the extent HF was to blame up to the date of audit completion (eg, 'black box' flight recorder evidence).
- Consider the possibility of counter claims by HF against others responsible for the crash by considering legal advice.
- Review any correspondence with Health and Safety Executive regarding grounding of planes or possible causes of the crash.
- Review flight bookings since crash for evidence of a decline in reputation and fall in future sales.
- Assess impact on budgeted cash flows to consider impact on going concern.

(2) Operating issues Financial reporting issues

- The decline in operating profits is further evidence of going concern problems.
- If the short-term leases have been extended then they will need to be recognised as right-of-use assets in the statement of financial position.

Audit risks

The key audit risk is going concern. If there is adequate disclosure in the financial statements by the directors regarding the uncertainties about going concern then an unmodified audit opinion will be issued but the audit report will include a separate section headed 'Material Uncertainty Related to Going Concern'. However, if the directors do not disclose going concern uncertainties appropriately, it may be necessary to modify the audit opinion.

The receipt of cash from customers in advance is likely to cause concern if the company does have going concern issues, as this may amount to fraudulent trading if the customers, as unsecured creditors, are unable to recover their payment.

The additional borrowing also increases financial risk and makes profit more sensitive to changes in the level of operating activity.

Audit procedures

As already noted, cash flow forecasts will need to be reviewed up to the date of audit completion to assess the future viability of the company. This should include the following:

- Examining overdraft and other lending facilities (eg, for 'headroom' against existing liabilities, for interest rates and for capital repayment dates). Build a picture of future financial commitments.
- Identifying the level of advanced payments and discuss with the directors the issue of continuing the policy of advanced payments and the implications for fraudulent trading.
- Examining budgets and cash flow projections as part of going concern. Review to assess future expected changes in liquidity.
- Examining lease contracts to assess the lease renewals position in order to ascertain future levels of commitment.

(3) Database system Audit risks

General systems issues

The nature of the fault needs to be identified ie, there may be issues with the work and or hardware/software supplied by the consultants. Some of the problems appear to be with the people operating the systems rather than the system itself. These are employees of the company so this effect also needs to be assessed.

Cyber security may also be an issue as a virus was able to circumvent existing security

measures. There appear to be two control risks in the IT system:

- The maintenance and control of the database itself and the information contained therein
- The online processing of transactions

Separate controls are needed over each of these aspects.

Specific issues

Excess bookings – risks include the following:

- A system error appears to have arisen, as the system should not accept unintentional double bookings. The level of confidence in the system is thus reduced, thereby increasing our assessment of control risk.
- Revenue may have been double counted if two bookings have been taken.

System crashing – risks include the following:

- Loss of data is a major problem, as it not only affects operating capability but also reduces confidence in IT controls over financial statement assertions as the database feeds into the financial statements.
- There may be a risk of corruption of data as well as loss of data. This may have been a cause of the above double bookings.

Computer virus – risks include the following:

- Loss of future data if it reoccurs
- Corruption of data
- Loss of confidentiality of information
- Risk of fraud from 'hacking' into system to create false bookings or false payments

Advance payments recognised as revenue:

- If payments are recognised as revenue on receipt, then revenue is overstated if payments occur in one financial year and the flight occurs in the next financial year. The risk is that all such payments recognised in advance have not been identified.

Financial reporting issues

The key financial reporting issue is the inappropriate recognition of revenue for advance payments by customers. While this can be corrected in the draft financial statements in the current year, it may have also have occurred in the previous year. If material, this should be recognised as a prior period error. Retained earnings brought forward should be adjusted and the relevant revenue should be correctly recognised in the current year with comparatives adjusted.

Audit procedures

The control risk relating to the IT system needs to be established. If reliance cannot be placed on the IT system it may not be possible to test income for understatement due to lack of relevant, reliable audit evidence. This may lead to a modified audit opinion on the basis of insufficient evidence (limitation of scope).

Regarding online processing, tests of controls with respect to the following may be relevant:

- Access controls, passwords (eg, review logs of access and user authorisation)
- Programming (review programming faults discovered, actions taken to amend faults, reoccurrence of same faults)
- Firewall (consider response to virus and why firewall failed to detect it; procedures for updating firewalls; best practice review)
- Use of CAATs to interrogate the system's ability to detect and prevent errors and fraud

Regarding database itself:

- Review procedures manuals for database management system. This is the software that creates, operates and maintains the database.
- Review data independence procedures (the data should be independent of the application such that the structure of the data can be changed independently of the application).
- Consider the wider database control environment. This includes the general controls and who has access to change particular aspects of the database.
- General controls might include: a standard approach for development and maintenance of application programs; access rights; data resource management; data security, cyber-security and data recovery.

Chapter 8

The statutory audit: finalisation, review and reporting

Introduction

Learning outcomes

- Appraise the appropriateness of the going concern basis of accounting and evaluate relevant going concern disclosures
- Appraise and assess the significance of events after the reporting period
- Evaluate, quantitatively and qualitatively, using analytical procedures and appropriate data analysis tools, the results and conclusions obtained from audit procedures
- Conclude and justify the nature of the report on an audit engagement, and formulate an opinion for a statutory audit, which are consistent with the results of the audit evidence gathered
- Compose suitable extracts for reports (for example any report to the management or those charged with governance issued as part of the engagement)
- Appraise 'other information' in the annual report and report on material misstatements in this information and material inconsistencies with the financial statements

Specific syllabus references for this chapter are: 15(a)–(f)

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	**Review and audit completion** In order to be ready to conclude the audit, there are several completion standards that the auditor must address.	**Approach** Most of this is revision from your previous studies so run through it again with your auditing standards open book in front of you. **Stop and think** Note how AI and RPA can be applied to this completion stage.	If this is examined, you will need to refer to the appropriate auditing standard to ensure that each of these completion tasks has been addressed.	N/A
2	**Subsequent events** This section should serve as a reminder that there will always be events that could affect the audit regardless of when they occur.	**Approach** This is also revision so make sure you remember the key messages. **Stop and think** Do you remember	You should always be alert to the risk that subsequent events could derail the audit at any point so read the scenario carefully.	**IQ1: Subsequent events** To answer this question, you will need to ask yourself when the oil leak actually took place.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
		this from your previous studies?		
3	**Going concern** Confirming the going concern status of an entity is fundamental to preparing a set of financial statements: consequently, the auditor needs to know how to assess this.	**Approach** Responsibilities, indicators and responses to going concern issues are all revision from your previous studies, so make sure you find the relevant sections of ISA 570 in your auditing standards open book. **Stop and think** Reporting responsibilities are complex and depend on how well any going concern issues have been disclosed by management – can you remember what to do in various situations?	Going concern can straddle many different disciplines in an exam question, from the use of analytical procedures to assess viability and qualitative evaluation via the scenario all the way through to how the auditor's report could be affected in various situations. You therefore need to practise questions in order to be fully prepared.	**IQ2: Going concern** This is a very practical example that requires good analytical skills as well as sound logic when deciding the most appropriate responses to your analysis.
4	**Comparatives** The auditor's responsibilities to audit the financial statements extend to include the previous year's figures as well.	**Approach** This will be revision from your previous studies so make sure you remember where to find this content. **Stop and think** Do this year's comparatives match last year's figures? Should they?	Comparative figures are usually presented as part of a set of financial statements but the requirements of ISAs 510 and 710 may be tested by a scenario which includes change of some kind (such as a new auditor or a change in accounting policies).	N/A
5	**Written representations** Another of the auditor's 'pre-flight checks' before they	**Approach** Without obtaining these representations, the auditor does not	These could form part of the overall evidence that the auditor needs to collect, so you	**IQ3: Written representations** This is a good test of whether you understand (a) the

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	can issue their opinion is to obtain representations from management.	have all the evidence they need for their opinion. **Stop and think** Can you remember what happens if the client refuses to provide these representations to the auditor?	should be prepared for any situations where representations might be required.	purpose of obtaining representations and (b) the process.
6	**The auditor's report** This is the auditor's opportunity to explain what they have achieved during the course of the engagement and requires great skill and judgement to prepare.	**Approach** There are many elements to this section: the report structure, key audit matters, any necessary modifications and the auditor's responsibilities for other information. None of this is new material but you still need to be prepared in case it is examined. **Stop and think** Can you differentiate between situations where you might only need to modify the auditor's report and those where the audit opinion requires modifying?	There is plenty of scope for questions on the auditor's report to appear in your exam – this content may also be added to another requirement where you need to consider the impact of your findings on the auditor's report and/or the opinion. Be prepared!	**IQ4: Forming an audit opinion** This is a great illustration of the job of the auditor – unless you can explain that there is a problem with the accounting treatment here, there is a risk that you will issue an unmodified opinion despite the possible presence of accounting irregularities. Reporting therefore requires strong corporate reporting knowledge in conjunction with your audit reporting knowledge. Don't forget about materiality!
7	**Other reporting responsibilities** Some engagements require specific reporting which you also need to be familiar with.	**Approach** You should have covered most of this in your previous studies so this should be revision. **Stop and think** How do you think XBRL tagging fits into the new digital workplace?	Questions on these topics may only represent a handful of marks, but you still need to be prepared to explain the auditor's responsibilities if required.	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive questions
8	**Appendix** You need to be familiar with the various modifications to the auditor's report under different circumstances.	**Approach** You covered this in your previous studies so this should be revision. **Stop and think** Can you find each of these in the auditing standards open book?	You need to know which parts of the report would need to be modified under certain situations and explain the reasons why.	N/A

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Review and audit completion

Section overview

- Towards the end of an audit, a series of reviews and evaluations are carried out.
- This is an important aspect of quality management.

1.1 Introduction

Auditing initially may be carried out on components, with opinions being formed on elements of the financial statements in isolation. However, it is essential that auditors step back from the detail and assess the financial statements as a whole, based on knowledge accumulated during the audit process. In particular, the following procedures will need to be performed at the review and completion stage of the audit:

- Consider governance issues
- Review the financial statements
- Perform completion procedures
- Report to the board
- Prepare the auditor's report

Review and reporting issues have been covered in the Audit and Assurance Workbook at the Professional Level, however, there have been some substantial changes over recent years in this area affecting the auditor's responsibilities relating to 'other information' and auditor's reports in particular. The following ISAs are relevant to this stage of the audit:

- ISA 260 (Revised), *Communication With Those Charged With Governance*
- ISA 520, *Analytical Procedures*
- ISA 560, *Subsequent Events*
- ISA 570 (Revised), *Going Concern*
- ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*
- ISA 701 , *Communicating Key Audit Matters in the Independent Auditor's Report*
- ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*
- ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*
- ISA 710, *Comparative Information – Corresponding Figures and Comparative Financial Statements*
- ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*

In the remainder of this chapter we will look at a number of key aspects of these ISAs in more detail. A summary is also provided in the technical reference at the end of the chapter.

1.2 Governance issues

1.2.1 Quality management

We have looked at the importance of quality management in Chapter 1 of this Workbook. Quality is an important consideration throughout the audit. In particular, for the audit of listed entities, ISA 220 (Revised), *Quality Management for an Audit of Financial Statements* states that the auditor's report should not be dated until the completion of the engagement quality review (ISA 220.36d).

This includes ensuring that:

- the work has been carried out in accordance with professional and regulatory requirements;
- a proper evaluation of the firm's independence was carried out;
- significant matters are given further consideration;
- appropriate consultations have taken place and been documented;
- where appropriate the planned work is revised;
- the work performed supports the conclusions;
- the evidence obtained supports the audit opinion;
- the objectives of the audit have been achieved; and
- the auditor's report is appropriate in the circumstances.

In addition, under Sarbanes–Oxley, a concurring or second partner review should be performed by another partner not associated with the audit or by an independent reviewer (see Chapter 4 for more details of the Sarbanes–Oxley Act 2002 or SOX).

In its 'Strategy 2018/21: Budget and Levies 2018/19 (March 2018)' the UK FRC reiterated that "promoting high audit quality and assurance" was one of its **strategic priorities** – this is underpinned by its ongoing system of monitoring the quality of firms and their work, including periodic audit quality thematic reviews on issues such as materiality (see Chapter 5).

1.2.2 Governance evidence

Important governance evidence will be obtained from the following sources:

- Written representation letters from management (see later in this chapter)
- Information about contingent liabilities and commitments (Chapter 13)
- Information about related parties (Chapter 9)

1.3 Financial statement review

1.3.1 Introduction

Once the bulk of the substantive procedures have been carried out, the auditors will have a draft set of financial statements which should be supported by appropriate and sufficient audit evidence. At the beginning of the end of the audit process, it is usual for the auditors to undertake an **overall review** of the financial statements. This review, in conjunction with the conclusions drawn from the other audit evidence obtained, gives the auditors **a reasonable basis for their opinion** on the financial statements. It should be carried out by a senior member of the audit team, with appropriate skills and experience.

1.3.2 Compliance with accounting regulations

The auditors should consider whether:

- the **information presented** in the financial statements is **in accordance with local/national statutory requirements**; and
- the **accounting policies** employed are in accordance with accounting standards, properly disclosed, consistently applied and appropriate to the entity.

An important consideration in assessing the presentation of the financial statements is the adequacy of disclosure..

When examining the **accounting policies**, auditors should consider:

- policies commonly adopted in particular industries;
- policies for which there is substantial authoritative support;

- whether any departures from applicable accounting standards are necessary for the financial statements to give a true and fair view; and
- whether the financial statements reflect the substance of the underlying transactions and not merely their form.

When compliance with local/national statutory requirements and accounting standards is considered, the auditors may find it useful to use a **checklist**.

1.3.3 Review for consistency and reasonableness

The auditors should consider whether the financial statements are consistent with their knowledge of the entity's business and with the results of other audit procedures, and the manner of disclosure is fair. The principal considerations are as follows.

- Whether the financial statements adequately reflect the **information** and **explanations** previously obtained and conclusions previously reached during the course of the audit
- Whether the review reveals any **new factors** which may affect the presentation of, or disclosure in, the financial statements
- Whether analytical procedures applied when completing the audit, such as comparing the information in the financial statements with other pertinent data, **produce results** which assist in arriving at the overall conclusion as to whether the financial statements as a whole are consistent with their knowledge of the entity's business
- Whether the **presentation** adopted in the financial statements may have been unduly influenced by the **directors' desire** to present matters in a favourable or unfavourable light
- The potential impact on the financial statements of the **aggregate of uncorrected misstatements** (including those arising from bias in making accounting estimates) identified during the course of the audit

1.3.4 Analytical procedures

In Chapter 6, we discussed how **analytical procedures** are used as part of the **overall review procedures** at the end of an audit. The procedures may be similar to those performed at the planning stage as risk assessment procedures but, at the end of the audit, the purpose of the procedures is to corroborate the conclusions drawn during detailed testing. This may also involve reviewing results derived from data analytics tools.

As at other stages, significant fluctuations and unexpected relationships must be investigated and documented.

1.3.5 Summarising misstatements

During the course of the audit, misstatements will be discovered which may be material or immaterial to the financial statements. It is very likely that the client will adjust the financial statements to take account of these during the course of the audit. At the end of the audit, however, some misstatements may still be uncorrected and the auditors will summarise these **uncorrected misstatements**.

An example is provided below.

Context example: Schedule of uncorrected misstatements

		SoPL (Current period) Dr £	SoPL (Current period) Cr £	SoFP (Current period) Dr £	SoFP (Current period) Cr £	SoPL (Prior period) Dr £	SoPL (Prior period) Cr £	SoFP (Prior period) Dr £	SoFP (Prior period) Cr £
(a)	ABCLtd debt unprovided	10,470			10,470	4,523			4,523
(b)	Opening/ closing inventory underval'd*	21,540			21,540		21,540	21,540	
(c)	Closing inventory underval'd		34,105	34,105					
(d)	**Opening unaccrued expenses**								
	Telephone*		453	453		453			453
	Electricity*		905	905		905			905
(e)	**Closing unaccrued expenses**								
	Telephone	427			427				
	Electricity	1,128			1,128				
(f)	Obsolete inventory write -off	2,528			2,528	3,211			3,211
	Total	36,093	35,463	35,463	36,093	9,092	21,540	21,540	9,092
	Cancelling items*	21,540			21,540				
			453	453					
			905	905					
		14,553	34,105	34,105	14,553				

The summary of misstatements will list misstatements not only from the current year (adjustments (c) and (e)) but also those in the previous year(s). This will allow misstatements to be highlighted which are reversals of misstatements in the previous year. For example, in this instance last year's closing inventory was undervalued by £21,540 (adjustment (b)). Inventory in the prior year statement of financial position should be increased (Dr) and profits increased (Cr). At the start of the current accounting period the closing inventory adjustment is reversed out so that the net effect on the cumulative position is zero. This also applies to the adjustment to last year's accrued expenses (adjustment (d)). Cumulative misstatements may also be shown, which have increased from year to year, for example adjustments (a) and (f). It is normal to show both the statement of financial position and the effect on profit or loss, as in the example given here. This may also be extended to the entire statement of profit or loss and other comprehensive income.

1.3.6 Evaluating the effect of misstatements

ISA 450, *Evaluation of Misstatements Identified During the Audit* states that the objective of the auditor is to evaluate:

(a) the effect of identified misstatements on the audit, and

(b) the effect of uncorrected misstatements, if any, on the financial statements. (ISA 450.3)

All misstatements identified during the audit should be accumulated, other than those that are clearly trivial (ISA 450.5). (The ISA explains that 'clearly trivial' does not mean the same as 'not material'; it implies something of a wholly different – smaller – order of magnitude.) The auditor must document any threshold used to define what has been considered to be clearly trivial.

The aggregate of uncorrected misstatements comprises the following:

(a) **Specific misstatements** identified by the auditors, including the net effect of uncorrected misstatements identified during the audit of the previous period if they affect the current period's financial statements

(b) Their **best estimate** of **other misstatements** which cannot be quantified specifically

ISA 450 distinguishes between the following:

- **Factual misstatements** – about which there is no doubt
- **Judgemental misstatements** – differences arising from judgements of management including those concerning recognition, measurement, presentation and disclosure in the financial statements (including the selection or application of accounting policies) that the auditor considers unreasonable or inappropriate
- **Projected misstatements** – the auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in samples to entire populations

  (ISA 450.A6)

  If the auditors consider that the **aggregate** of misstatements may be material, they must consider reducing audit risk by extending audit procedures or requesting management to adjust the financial statements (which management may wish to do anyway).

  If the aggregate of the uncorrected misstatements that the auditors have identified approaches the materiality level, the auditors should consider whether it is likely that undetected misstatements, when taken with aggregated uncorrected misstatements, could exceed the materiality level. Thus, as aggregate uncorrected misstatements approach the materiality level the auditors should consider reducing the risk by:

- performing **additional audit procedures**; and
- requesting management to **adjust the financial statements** for identified misstatements.

The schedule will be used by the audit manager and partner to decide whether the client should be requested to make adjustments to the financial statements to correct the misstatements.

Professional skills focus: Structuring problems and solutions

Audits are generally very procedural and as such can be quite complex when trying to complete all the stages in order to form an audit opinion and report it accordingly. Knowledge of the various auditing standards here will provide a sound structure for ensuring that all the necessary elements of the engagement have been completed.

1.4 Artificial intelligence (AI) and robotic process automation (RPA)

In Chapter 5 we discussed the advances in audit data analytics and how artificial intelligence (AI) and robotic process automation (RPA) have helped auditors to increase the scope, detail and accuracy of testing large populations of data. This software can even be programmed to summarise findings and prioritise the results of testing, making the process of evaluation more efficient as the parameters that are used to identify items of significance can now be programmed with much more subtlety (for example, the patterns of behaviours which may be indicative of fraudulent activity within an account category such as expenses claims).

2 Subsequent events

Section overview

Auditors must review events after the reporting period and determine whether those events impact on the year-end financial statements.

2.1 Events after the reporting period

In accordance with ISA 560, *Subsequent Events*, subsequent events include:

- events occurring **between the period end and the date of the auditor's report**; and
- facts discovered **after the date of the auditor's report**.

IAS 10, *Events After the Reporting Period* deals with the treatment in financial statement of events, favourable and unfavourable, occurring after the period end. It identifies two types of event:

(a) Those that provide further evidence of **conditions that existed at the period end**

(b) Those that are indicative of **conditions that arose subsequent to the period end**

The extent of the auditor's responsibility for subsequent events depends on when the event is identified.

Note: While ISA 560 does not deal with matters relating to the auditor's responsibilities for other information obtained after the date of the auditor's report which are addressed in ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*, this type of other information may bring to light a subsequent event relevant to the application of ISA 560.

2.2 Events occurring up to the date of the auditor's report

The auditor must perform procedures designed to obtain **sufficient, appropriate audit evidence** that all events **up to the date of the auditor's report** that may require adjustment of, or disclosure in, the financial statements have been identified. In summary, these procedures consist of making enquiries of management about changes or risks, and inspecting relevant documentation (such as board minutes and any internally available financial information such as management accounts).

These procedures should be applied to any matters examined during the audit which may be susceptible to change after the period end, in addition to tests on specific related transactions eg, cut-off tests.

The ISA lists **procedures** to identify subsequent events which may require adjustment or disclosure. They should be performed as near as possible to the date of the auditor's report.

Reviews and updates of these procedures may be required, depending on the length of the time between the procedures and the signing of the auditor's report and the susceptibility of the items to change over time.

When the auditor becomes aware of events which materially affect the financial statements, the auditor should consider whether such events are **properly accounted for and adequately disclosed** in the financial statements.

2.3 Facts discovered after the date of the auditor's report but before the financial statements are issued

The financial statements are the **management's responsibility**. They should therefore inform the auditors of any material subsequent events **between the date of the auditor's report and the date the financial statements are issued**. The auditors do **not** have any obligation to perform procedures, or make inquiries regarding the financial statements **after the date of their report**.

If, after the date of the auditor's report but before the financial statements are issued, the auditor becomes aware of a fact that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

- Discuss the matter with the management;
- Consider whether the financial statements need amendment; and if so
- Inquire how management intends to address the matter in the financial statements.

When the financial statements are amended, the auditors shall do the following:

- **Extend the procedures** discussed above to the **date of their new report**
- Carry out any other appropriate procedures
- Issue a new auditor's report dated no earlier than the date of approval of the amended financial statements

If the auditor believes the financial statements need to be amended, and management does not amend them:

- If the auditor's report **has not yet been released** to the entity, the auditor shall modify the opinion in line with ISA 705 and then provide the auditor's report.
- If the auditor's report **has already been released** to the entity, the auditor shall notify those who are ultimately responsible for the entity (the management or possibly a holding company in a group) not to issue the financial statements or auditor's reports before the amendments are made. If the financial statements are issued anyway, the auditor shall take action to **seek to prevent reliance on the auditor's report**. The action taken will depend on the auditor's legal rights and obligations and the advice of the auditor's lawyer.

2.4 Facts discovered after the financial statements have been issued

Auditors have **no obligations** to perform procedures or make inquiries regarding the financial statements **after they have been issued**. This may include the period up until the financial statements are authorised for issue by those charged with governance.

When, after the financial statements have been issued, the auditor becomes aware of a fact which existed at the date of the auditor's report and which, if known at that date, may have caused the auditor to modify the auditor's report, the auditor should consider whether the financial statements need revision, discuss the matter with management, and take action as appropriate in the circumstances.

The ISA gives the appropriate procedures which the auditors should undertake when management revises the financial statements.

- **Carry out the audit procedures** necessary in the circumstances.

- **Review the steps taken by management** to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation.
- **Issue a new report** on the revised financial statements.

(ISA 560.15)

The new auditor's report should include an **emphasis of matter paragraph** or **other matter paragraph** referring to a note to the financial statements that more extensively discusses the reason for the revision of the previously issued financial statements and to the earlier report issued by the auditor.

(ISA 560.16)

Where local regulations allow the auditor to restrict the audit procedures on the financial statements to the effects of the subsequent event which caused the revision, the new auditor's report should contain a statement to that effect.

Where management does **not** revise the financial statements but the auditors feel they should be revised, or if management does not intend to take steps to ensure anyone in receipt of the previously issued financial statements is informed of the situation, the auditors should consider taking steps to prevent reliance on their report. The actions taken will depend on the auditor's legal rights and obligations and legal advice received. In Bangladesh , the auditor has a legal right to make statements at the AGM.

Where the auditor becomes aware of a fact relevant to the audited financial statements which **did not exist** at the date of the auditor's report, there are no statutory provisions for revising the financial statements. In this situation, the auditor discusses with those charged with governance whether they should withdraw the financial statements. Where those charged with governance decide not to do so, the auditor may wish to take advice on whether it might be possible to withdraw their report. In either case, other possible courses of action include those charged with governance or the auditors making a statement at the AGM.

Professional skills focus: Assimilating and using information

Gaining full visibility of the timescales involved in a scenario is essential for the satisfactory resolution of a requirement. This will therefore help you fully visualise the problem so it can be resolved.

Interactive question 1: Subsequent events

You are the auditor of Extraction, an oil company. You have recently concluded the audit for the year ended 31 December 20X7 and the auditor's report was signed on 28 March 20X8. The financial statements were also authorised for issue on this date. On 1 April, you are informed that the company has identified a major oil leak which has caused significant environmental damage.

Requirement

Identify and explain the implications of the information regarding the oil spill. See **Answer** at the end of this chapter.

3 Going concern

Section overview

- The auditor will test whether the going concern basis of accounting is appropriate to ensure it applies to the audit client.
- Financial risk is indicated by the following circumstances:
- Financial indications
- Operating indications
- Other indications

3.1 Reporting consequences

If an entity is a going concern it is ordinarily viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulations. Accordingly, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities **in the normal course of business**.

However, if management determines that it intends to, or has no realistic alternative but to, liquidate the entity or cease trading, then **the financial statements should not be prepared on the going concern basis.** This is specified by IAS 10, *Events After the Reporting Period*. The entity should instead adopt a basis of preparation that is considered more appropriate in the circumstances, although no specific guidance is provided in IAS 10. In practice, the most obvious method is **break-up** or **liquidation basis**. Specific accounting consequences will include the need to consider the following:

- Impairment of assets
- Recognition of provisions eg, for onerous contracts

Disclosure of the change of basis of preparation should be provided in accordance with IAS 1, *Preparation of Financial Statements*. In addition, the directors of listed companies must report specifically on the going concern status of the company..

3.2 Financial risk

The possibility of a business not being a going concern is one of the financial risks to which a business is exposed. Financial risks are those risks arising from the financial activities of the company, for example:

- Raising capital
- The capital structure
- Financial consequences of an operation eg, operating in an overseas environment

As a consequence of the original capital structure or subsequent operation, there may be a risk due to a shortage of finance or an inability to manage finance in accordance with a company's day to day requirements.

ISA 570 (Revised), *Going Concern* identifies events and conditions that may cast doubt about the entity's ability to use the going concern basis of accounting, under the headings of **financial, operating** and **other** (ISA 570, para. A3).

The significance of such indications can often be **mitigated** by other factors, for example:

(a) the effect of an entity being unable to make its normal debt repayments may be counterbalanced by management's plans to maintain **adequate cash flows** by alternative means, such as by disposal of assets, rescheduling of loan repayments, or obtaining additional capital.

(b) the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

3.3 ISA 570, *Going Concern*

The following is a summary of the key points from the revised ISA.

Management's responsibility

(a) ISA 570 states that when preparing accounts, management should make an explicit **assessment** of the entity's ability to continue as a going concern.

(b) When management are making the assessment, the following factors should be considered:

  (1) The **degree of uncertainty** about the events or conditions being assessed increases significantly the further into the future the assessment is made.

  (2) Judgements are made on the basis of the **information available** at the time.

  (3) Judgements are affected by the **size** and **complexity** of the entity, the **nature** and **condition** of the business and the **degree** to which it is **affected** by **external factors**.

Auditor's responsibilities

(a) When planning and performing audit procedures and in evaluating the results thereof, the auditor shall consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

(b) The auditor's objectives are as follows:

  (1) To obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting

  (2) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern

  (3) To report in accordance with ISA 570 (ISA 570.9)

(c) The auditor shall remain alert for evidence of events or conditions and related business risks which may cast doubt on the entity's ability to continue as a going concern throughout the audit. If such events or conditions are identified, the auditor shall consider whether they affect the auditor's assessments of the risk of material misstatement.

(d) Management may already have made a preliminary assessment of going concern. If so, the auditors would review potential problems management had identified, and management's plans to resolve them. Alternatively auditors may identify problems as a result of discussions with management.

(e) The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern maintaining professional scepticism and an awareness of the risk of **management bias** throughout the audit. The auditors shall consider:

  (1) the **process** management used and the **robustness** of the assessment of the company's risks;

  (2) the **assumptions** on which management's assessment is based; and

  (3) management's **plans** for future action.

(f) If management's assessment covers a period of **less than 12 months** from the end of the reporting period, the auditor shall ask management to extend its assessment period to 12 months from the end of the reporting period.

(ISA 570.14-1)

(g) Management shall not need to make a detailed assessment if the entity has a history of profitable operations and ready access to financial resources. In this case, the auditor's evaluation of the assessment may be made without performing detailed procedures if sufficient evidence is available from other audit procedures. The extent of the auditor's procedures is influenced primarily by the excess of the financial resources available to the entity over the financial resources that it requires.

(ISA 570.A9)

(h) The auditor shall inquire of management as to its knowledge of events or conditions beyond the period of assessment used by management that may cast significant doubt on the entity's ability to continue as a going concern. The auditor remains alert to the possibility that there may be known events, scheduled or otherwise, or conditions that will occur beyond the period of assessment used by management that may bring into question the appropriateness of management's use of the going concern basis of accounting in preparing the financial statements. If such events or conditions are identified, the auditor may need to request management to evaluate the potential significance of the event or condition on its assessment of the entity's ability to continue as a going concern.

(ISA 570.A14)

As the degree of uncertainty increases as an event or condition gets further into the future, the indications of going concern issues would need to be significant before the auditor would consider it necessary to take any further action based on this information. The auditor's responsibility to carry out procedures to identify issues beyond the period of assessment would normally be limited to inquiries of management.

(ISA (UK) 570.A14)

Additional audit procedures

(a) When events or conditions have been identified which may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall do the following:

(1) Evaluate management's plans for future actions based on its going concern assessment

(2) Where the entity has prepared a cash flow forecast and analysis of this is significant in the evaluation of management's plans for future action:

- Evaluate the reliability of the underlying data
- Determine whether there is adequate support for the assumptions underlying the forecast

(3) Consider whether any additional facts or information have become available since the date of management's assessment

(4) Seek written representations from management regarding its plans for future action and the feasibility of these plans

(b) When questions arise on the appropriateness of the going concern assumption, some of the normal audit procedures carried out by the auditors may take on an **additional significance**. Auditors may also have to carry out **additional procedures** or update information obtained earlier. The ISA lists various procedures which the auditors shall carry out in this context.

(1) **Analyse and discuss cash flow**, profit and other relevant forecasts with management.

(2) **Analyse and discuss** the entity's latest available **interim financial statements**.

(3) **Read the terms of debentures and loan agreements** and determine whether they have been breached.

(4) **Read minutes** of the meetings of shareholders, the board of directors and important committees for reference to financing difficulties.

(5) **Inquire** of the entity's lawyer regarding **litigation and claims**.

(6) **Confirm the existence, legality and enforceability** of arrangements to provide or maintain financial support with related and third parties.

(7) **Assess** the **financial ability** of such parties to **provide additional funds**.

(8) Evaluate **the entity's plans to deal with unfulfilled customer orders**.

(9) Perform audit procedures regarding **subsequent events** to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.

(10) **Confirm** the existence, terms, and adequacy of **borrowing facilities**.

(11) **Obtain and review** reports of **regulatory actions**.

(12) **Determine the adequacy** of support for any planned **disposals of assets**.

(c) Based on the audit evidence obtained, the auditor shall determine if, in the auditor's judgement, a material uncertainty exists related to events or conditions that, alone or in aggregate, may cast significant doubt on the entity's ability to continue as a going concern. The auditor must document the extent of their concern (if any) about the entity's ability to continue as a going concern.

Going concern – auditor conclusions and reporting

Use of going concern basis of accounting appropriate but a material uncertainty exists

(a) The auditor shall determine whether the financial statements:

(1) adequately disclose the **events and conditions** that may cast significant doubt on the entity's ability to continue as a going concern and **management's plans** to deal with these; and

(2) disclose clearly that there is a **material uncertainty** which may cast significant doubt about the company's ability to continue as a going concern.

(b) If **adequate disclosure** is made in the financial statements, the auditor shall express an unmodified opinion but include a separate section under the heading 'Material Uncertainty Related to Going Concern'. This must draw attention to the note in the financial statements that discloses the matter and must state that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in this respect.

(ISA 570.22 and Appendix: Illustration 1)

(c) If **adequate disclosure is not made** in the financial statements, the auditor shall express a qualified or adverse opinion, as appropriate. In the Basis for Qualified or Adverse Opinion section of the auditor's report the auditor must state that there is a material uncertainty which may cast significant doubt on the company's ability to continue as a going concern and that the financial statements do not adequately disclose this.

(ISA 570.23)

Management unwilling to make or extend its assessment

- If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor shall consider the need to modify the auditor's report as a result of the inability to obtain sufficient appropriate evidence. A qualified opinion or a disclaimer of opinion in the auditor's report may be appropriate. (ISA 570.A35)

Use of going concern assumption is inappropriate

- If the going concern basis has been used but in the auditor's judgement this is not appropriate, the auditor shall express an **adverse opinion**.

Communication with those charged with governance

Unless all those charged with governance are involved with managing the entity the auditor must communicate with those charged with governance events or conditions that cast significant doubt on the entity's ability to continue as a going concern, including the following details:

- Whether the events or conditions constitute a material uncertainty
- Whether management's use of the going concern basis of accounting is appropriate
- The adequacy of related disclosure
- Where applicable the implications for the auditor's report

(ISA 570.25)

Significant delay

If there is a significant delay in the approval of the financial statements the auditor must enquire as to the reasons for this. Where it is believed that the delay could be related to going concern issues the auditor must perform additional audit procedures and consider the effect on the auditor's conclusion regarding the existence of a material uncertainty.

Professional skills focus: Applying judgement

When evaluating a company's going concern status, it is rarely a case of 'yes' or 'no' but instead is more likely to be 'maybe' and 'it depends'. You will need to identify those factors from the scenario that point you in the right direction and reach an overall conclusion about this using your professional judgement.

3.4 Other guidance

The responsibility for assessing the company's ability to continue as a going concern and for disclosing significant uncertainties rests with the directors. The UK Financial Reporting Council (FRC) has published *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting* in September 2014 which replaces an *Update for Directors: Going Concern and Liquidity Risk*. This is primarily directed at companies subject to the UK Corporate Governance Code and aims to bring together elements of best practice for risk management. Appendix A specifically deals with going concern and provides guidance on how to determine whether to adopt the going concern basis, how to determine whether there are material uncertainties and relevant disclosures.

In April 2016 UK FRC issued *Guidance on the Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risk*. This provides guidance to directors of companies that do not apply the UK Corporate Governance Code. This includes principles for best practice. It summarises the main requirements as follows:

Main requirement	Micro-entity	Small company	Large or medium- sized company
Financial statements			
Assessment of appropriateness of the going concern basis of accounting	α	α	α
Disclosure when there are material uncertainties or when the company does not prepare financial statements on a going concern basis of accounting	×	×	×
Additional disclosures that may be required to give a true and fair view	×	α	α
Other relevant financial statement disclosures	×	×	α
Strategic report			
The strategic report must contain a description of the principal risks and uncertainties facing the company	×	×	α

Note: In June 2012, the Sharman Inquiry issued its Final Report and Recommendations. This includes recommendations regarding going concern assessment and disclosure (see Chapter 4).

Interactive question 2: Going concern

You are the senior on the audit of Truckers Ltd whose principal activities are road transport and warehousing services, and the repair of commercial vehicles.

You have been provided with extracts from the draft accounts for the year ended 31 October 20X5.

	Draft 20X5 £'000	Actual 20X4 £'000
Summary statement of profit or loss		
Revenue	10,971	11,560
Cost of sales	(10,203)	(10,474)
Gross profit	768	1,086
Administrative expenses	(782)	(779)
Interest payable and similar charges	(235)	(185)
Net (loss) profit	(249)	122
Summary statement of financial position		
Non-current assets	5,178	4,670
Current assets		
Inventory (parts and consumables)	95	61
Receivables	2,975	2,369
	3,070	2,430
Current liabilities		
Bank loan	250	-
Overdraft	1,245	913
Trade payables	1,513	1,245
Lease obligations	207	-

	Draft 20X5	Actual 20X4
	£'000	£'000
Other payables	203	149
	3,418	2,307
Non-current liabilities		
Bank loan	750	1,000
Lease obligations	473	
	1,223	1,000
Net assets	3,607	3,793

You have been informed by the managing director that the fall in revenue is due to the following factors:

- The loss, in July, of a longstanding customer to a competitor
- A decline in trade in the repair of commercial vehicles

Due to the reduction in the repairs business, the company has decided to close the workshop and sell the equipment and spares inventory. No entries resulting from this decision are reflected in the draft accounts.

During the year, the company replaced a number of vehicles, funding them by a combination of leasing and an increased overdraft facility. The facility is to be reviewed in January 20X6 after the audited accounts are available.

The draft accounts show a loss for 20X5 but the forecasts indicate a return to profitability in 20X6, as the managing director is optimistic about generating additional revenue from new contracts.

Requirements

2.1 State the circumstances particular to Truckers Ltd which may indicate that the company is not a going concern. Explain why these circumstances give cause for concern.

2.2 Describe the audit procedures to be performed in respect of going concern at Truckers Ltd. See **Answer** at the end of this chapter.

4 Comparatives

Section overview

- ISA 710 provides guidance on corresponding figures and comparative financial statements.
- The auditor should obtain sufficient, appropriate audit evidence that the corresponding figures meet the requirements of the applicable financial reporting framework.

4.1 ISA 710, *Comparative Information*

ISA 710, *Comparative Information – Corresponding Figures and Comparative Financial Statements* establishes standards and provides guidance on the auditor's responsibilities regarding comparatives.

Comparatives are presented differently under different countries' financial reporting frameworks. Generally comparatives can be defined as **corresponding amounts** and **other disclosures** for the preceding financial reporting period(s), presented for comparative purposes. Because of these variations in countries' approach to comparatives, the ISA refers to the following frameworks and methods of presentation.

Corresponding figures are amounts and other disclosures for the prior period included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as 'current period figures'). The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.

Comparative financial statements are amounts and other disclosures for the prior period included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor's opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period.

Comparatives are presented in compliance with the relevant financial reporting framework. The essential audit reporting differences are that:

- for **corresponding figures**, the auditor's report only refers to the financial statements of the current period; and
- for **comparative financial statements**, the auditor's report refers to each period for which financial statements are presented.

ISA 710 provides guidance on the auditor's responsibilities for comparatives (the audit procedures are essentially the same for both approaches) and for reporting on them under the two frameworks.

4.2 Audit procedures

The auditor must obtain sufficient, appropriate audit evidence that the comparative information meets the requirements of the applicable financial reporting framework.

Audit procedures performed on the comparative information are usually limited to checking that the comparative information has been correctly reported and is appropriately classified. Auditors must assess whether the following are true:

- **Accounting policies** used for the comparative information are **consistent** with those of the current period or whether appropriate adjustments and/or disclosures have been made.
- Comparative information **agrees** with the **amounts** and other disclosures presented in the prior period or whether appropriate adjustments and/or disclosures have been made. This will include checking whether related opening balances in the accounting records were brought forward correctly.

If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, then additional audit procedures should be performed to obtain sufficient, appropriate audit evidence to determine whether a material misstatement exists.

Written representations are required for all periods referred to in the auditor's opinion and specific representations are also required regarding any restatement made to correct a material misstatement in prior period financial statements that affect the comparative information. In the case of corresponding figures representations are requested for the current period only because the auditor's opinion is on those financial statements which include corresponding figures.

When the financial statements of the prior period:

- have been audited by other auditors, or
- were not audited,

then the incoming auditors must assess whether the corresponding figures meet the conditions specified above and also follow the guidance in ISA 510, *Initial Audit Engagements – Opening Balances*.

4.3 Reporting

When the comparatives are presented as corresponding figures, the auditor should issue an auditor's report in which the **comparatives are not specifically identified** because the auditor's opinion is on the current period financial statements **as a whole**, including the corresponding figures.

The auditor's report will only make any specific reference to corresponding figures in the circumstances described below.

(a) When the auditor's report on the prior period, as previously issued, included a qualified opinion, disclaimer of opinion, or adverse opinion and the matter which gave rise to the modification is unresolved:

 (1) if the effects or possible effects of the matter on the current period's figures are material, the auditor's opinion on the current period's financial statements should be modified and the basis for modification paragraph of the report should refer to both periods in the description of the matter; or

 (2) in other cases the opinion on the current period's figures should be modified and the basis for modification paragraph should explain that the modification is due to the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

(b) In performing the audit of the current period financial statements, the auditors, in certain unusual circumstances, may become aware of a **material misstatement** that affects the prior period financial statements on which an unmodified report has been previously issued. If the prior period financial statements have not been revised and reissued, and the corresponding figures have not been properly restated and/or appropriate disclosures have not been made, the auditor shall express a qualified opinion or an adverse opinion in the report on the current period financial statements, modified with respect to the corresponding figures included therein.

4.4 Incoming auditors: additional requirements

When the prior period financial statements were audited by other auditors, **in some countries** the **incoming auditors can refer to the predecessor auditor's report** on the corresponding figures in the incoming auditor's report for the current period.

When the auditor decides to refer to another auditor, the incoming auditor's report should indicate:

- that the financial statements of the prior period were audited by the predecessor auditor;
- the type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and
- the date of that report.

The situation is slightly different if the prior period financial statements were **not audited**.

When the prior period financial statements are not audited, the incoming auditor must state in the auditor's report that the corresponding figures are unaudited.

However, the inclusion of such a statement does not relieve the auditors of the requirement to perform appropriate procedures regarding opening balances of the current period. If there is insufficient evidence about corresponding figures or inadequate disclosures, the auditor should **consider the implications for their report**.

In situations where the incoming auditor identifies that the corresponding figures are materially misstated, the auditor should request management to revise the corresponding figures or, if management refuses to do so, appropriately **modify the report**.

Note: In some countries the predecessor auditor must allow the successor auditor access to all relevant information in respect of the audit, including relevant working papers. For example, In the UK in accordance with Companies Act 2006 a predecessor auditor must allow the successor auditor access to all relevant information in respect of the audit, including relevant working papers. However no such regulation currently exists in Bangladesh.

5 Written representations

Section overview

- Written representations are normally obtained towards the end of the audit as a letter written by management and addressed to the auditor.
- Where there is doubt as to the reliability of written representations or if management refuse to provide representations, the auditor will need to reassess the level of assurance obtained from this source of evidence.

5.1 Representations

ISA 580 , *Written Representations* covers this area and states that the objectives of the auditor are as follows:

- To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor.
- To support other audit evidence relevant to the financial statements or specific assertions in the financial statements.
- To respond appropriately to the representations or if representations are not provided.

5.2 Management from whom written representations are requested

"The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned."

(ISA 580.9)

ISA 580 requires the auditor to determine the appropriate individuals from whom to seek written representations. In most cases this is likely to be management, as they would be expected to have sufficient knowledge of the way in which the entity's financial statements have been prepared. However, the ISA goes on to point out that in circumstances where others are responsible for the financial statements, for example those charged with governance, then they should be requested to provide the representations.

The ISA emphasises the need for management to make **informed representations**. In some cases the auditor may request that management confirms that it has made appropriate inquiries to enable it to do so.

5.3 Written representations

5.3.1 Management's responsibilities

ISA 580 specifies a number of general representations which management must provide. These are as follows:

- That management has fulfilled its responsibility for the **preparation and presentation** of the financial statements as set out in the terms of the audit engagement.
- Whether the financial statements are prepared and presented **in accordance with the applicable financial reporting framework**.
- That management has provided the auditor with **all the relevant information**.
- That **all transactions** have been recorded and are reflected in the financial statements.
- A description of **management's responsibilities**.

Notes

1 In Bangladesh, considering the Companies Act, 1994 and the Securities and Exchange Rules, 1987, auditor may obtain representation on the following additional matters:

- proper books of accounts as required by law have been kept by the Company;
- the statement of financial position and statement of profit or loss and other comprehensive income dealt with by the report are in agreement with the books of accounts and returns; and
- the expenditures incurred were for the purposes of the Company's business.

2. In case of banks and financial institutions similar additional representation can be obtained by the auditor considering industry specific laws and regulations.

5.3.2 Other written representations

Other written representations may be required regarding specific issues. These may be required due to the provisions of other ISAs (a list is given in Appendix 1 of ISA 580) or to support other audit evidence. In particular, written representations may be sought where sufficient, appropriate evidence cannot be obtained independently. This might be the case where an assertion is affected by judgement or management intent. For example, management intent would be an important factor in the valuation basis used to value investments.

However, the ISA stresses that written representations **do not provide sufficient, appropriate audit evidence on their own**. The fact that management has provided reliable written representations does not affect the nature and extent of other audit evidence that the auditor obtains.

The auditor may also consider it necessary to obtain other representations about the following.

- Whether the selection and application of accounting policies are appropriate
- Whether the following have been recognised, measured and presented (where relevant):
  - Plans or intentions that may affect the carrying value or classification of assets and liabilities
  - Liabilities, both actual and contingent

- Title to, or control over, assets, the liens or encumbrances on assets, and assets pledged as collateral
- Aspects of laws, regulations and contractual agreements that may affect the financial statements

- That management has communicated to the auditor all deficiencies in internal control of which management is aware

5.3.3 Threshold amount

The ISA allows for the possibility that the auditor may agree a 'threshold amount' above which matters cannot be regarded as clearly trivial.

5.4 Date of written representations

"The date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements. The written representations shall be for all the financial statements and periods referred to in the auditor's report."

(ISA 580.14)

Because written representations are audit evidence, the auditor's report cannot be dated before the date of the written representations.

Where a representation about a specific issue has been obtained during the course of the audit the auditor may request an updated written representation.

5.5 Form of written representations

"The written representation shall be in the form of a representation letter addressed to the auditor. If law or regulation requires management to make written public statements about its responsibilities and the auditor determines that such statements provide some or all of the representations required by paragraphs 10 or 11 (covered in paragraph 5.3.1 above), the relevant matters covered by such statements need not be included in the representation letter."

(ISA 580.15)

Appendix 2 of ISA 580 provides an illustrative example of a representation letter. It is not a standard letter, and representations will vary from one period to the next and from one company to another.

5.6 Doubts as to reliability

Where the auditor has concerns about the **competence, integrity and ethical values** of the management, the auditor must consider the effect this will have on the reliability of both oral and written representations.

In particular, if written representations are **inconsistent** with other audit evidence the auditor will need to perform audit procedures in an attempt to resolve the matter. If the situation remains unresolved, the auditor will need to consider the potential effect on the audit opinion.

Where the auditor concludes that representations about management's responsibilities regarding the preparation and presentation of financial statements and information provided to the auditor are not reliable, the audit opinion will be a **disclaimer**.

5.7 Written representations not provided

ISA 580 requires the following procedures to be followed where written representations are not provided.

- Discuss the matter with management

- Re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral and written) and evidence in general
- Take appropriate actions, including determining the possible effect on the audit opinion

Where management **does not provide representations about management's responsibilities** regarding the preparation and presentation of financial statements and information provided to the auditor, the audit opinion will be a **disclaimer**.

Interactive question 3: Written representations

You are an audit manager reviewing the completed audit file of Leaf Oil.

(1) There have been no events subsequent to the period end requiring adjustment in the financial statements.

(2) The company has a policy of revaluing properties on an annual basis. A large revaluation gain has been recorded for two properties in the year, on the basis that the directors believe that the property market is going to boom next year. However, the directors have not provided supporting evidence for the revaluation, and a survey of business property values in the area does not show any increase.

(3) The directors confirm that the company owns 75% of the newly formed company, Subsidiary, at the year end.

(4) The directors confirmed that the 500 gallons of oil in Warehouse B belong to Leaf Oil.

Requirement

Comment on whether you would expect to see these matters referred to in the written representation letter.

See **Answer** at the end of this chapter.

6 The auditor's report

Section overview

- Auditors must provide clear and understandable auditor's reports on the financial statements audited.
- As well as the standard auditor's report, the wording of the report may be changed to express a modified opinion, or an emphasis of matter or other matter paragraph may be added to the report.
- Listed company auditor's reports include a description of key audit matters.
- Modifications result either from material misstatements (disagreements) in the financial statements or from an inability to obtain sufficient, appropriate audit evidence (limitation on scope).
- The auditor's report must include a separate section with a heading 'Other Information'.
- Auditors must form, and then critically appraise, their audit opinion on the financial statements.
- Auditor's reports can be made available electronically; in this situation the auditor must ensure that their report is not misrepresented.

6.1 The standard unmodified auditor's report

ISA 700 (Revised) states that the auditor's report must contain the following:

(a) Title

The term 'independent auditor' is usually used in the title to distinguish the auditor's report from reports issued by others.

(ISA 700.21)

(b) Addressee

The auditor's report shall be addressed, as appropriate, based on the circumstances of the engagement. In Bangladesh in case of a public interest entity, the auditor is required to report to the company's members.

(ISA 700.22)

(c) Auditor's opinion

This is now required to be the first section of the auditor's report. It must have the heading 'Opinion' and in Bangladesh, in case of a public interest entity that is a company registered under the Companies Act, 1994, when an unmodified opinion is expressed, it must state clearly that the financial statements give a true and fair view.

(ISA 700.23 & .25)

This section must also:

- identify whose financial statements have been audited;
- state that the financial statements have been audited;
- identify the title of each statement comprising the financial statements;
- refer to the notes, including the summary of accounting policies; and
- specify the date of, or period covered by, each financial statement comprising the financial statements.

(ISA 700.24)

(d) Basis for opinion

This section must immediately follow the 'Opinion' section and must have the heading 'Basis for opinion'. It must include the following information:

- States that the audit was conducted in accordance with ISAs
- Refers to the section of the auditor's report that describes the auditor's responsibilities under the ISAs
- Includes a statement that the auditor is independent of the entity in accordance with relevant ethical requirements
- States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

(ISA 700.28)

Going concern

Where applicable the auditor must report on going concern in accordance with ISA 570 (see earlier section of this chapter).

(ISA 700.29)

Key audit matters

In the Bangladesh, a key audit matters section must be included in accordance with ISA 701 for audits of complete set of general purpose financial statements of listed entities. When the auditor is otherwise required by law or regulation or decides to communicate key audit matters in the auditor's report, the auditor shall do so in accordance with ISA 701

(ISA 700.30-31)

Other information

Where applicable, the auditor's report also includes a separate section with a heading 'Other information' (see later in this chapter).

(ISA 700.32 and ISA 720.21)

Responsibilities for the financial statements

The auditor's report must include a section with the heading 'Responsibilities of those charged with governance for the Financial Statements'. This includes a statement describing the responsibility of those charged with governance for:

- preparing financial statements that give a true and fair view;
- such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement; and
- assessing the ability of the entity to continue as a going concern, assessing whether the use of the going concern basis of accounting is appropriate and disclosing matters relating to going concern.

Auditor's responsibilities for the audit of the financial statements

ISA 700's requirements regarding the description of the auditor's responsibilities is extensive. These include statements:

- of the objectives of the auditor;
- that reasonable assurance is a high level of assurance but is not a guarantee that an audit will always detect a material misstatement;
- that misstatements can arise from fraud or error; and
- that the auditor exercises professional judgment and maintains professional scepticism throughout the audit.

This section also includes a description of an audit and includes the following points:

- The auditor assesses risks of material misstatement, designs and performs audit procedures and obtains sufficient, appropriate evidence to provide a basis for the audit opinion.
- The auditor obtains an understanding of internal control relevant to the audit.
- The appropriateness of accounting policies is assessed.
- The auditor concludes on the appropriateness of management's use of the going concern basis of accounting and whether a material uncertainty exists.
- The auditor communicates with those charged with governance regarding the planned scope and timing of the audit and significant findings.

(ISA 700.37– .40a)

For audits of listed entities the auditor's responsibilities section will also include the following:

- Confirmation that the auditor has provided those charged with governance with a statement that the auditor has complied with relevant ethical requirements regarding independence

- Where key audit matters are communicated a statement that the auditor determines these matters to be of the most significance in the audit. This applies to all entities for which key audit matters are communicated (not just listed companies).

(ISA 700.40b&c)

As per ISA the description of the auditor's responsibilities may be given in the body of the auditor's report, within an appendix to the auditor's report or by cross reference to the description maintained on a website by an appropriate authority, if any.

(ISA 700.41)

(e) Other reporting responsibilities

If the auditor addresses other reporting responsibilities in addition to those under ISAs, these must be addressed in a separate section of the auditor's report.

For example, in Bangladesh the Companies Act, 1994 and the Securities and Exchange Rules, 1987 require the auditor to report if a company has maintained proper books of accounts.

(ISA 700.43)

Additional requirements may apply for audits of bank and non-bank financial institutions

(ISA 700.45

(f) Name of the engagement partner

The name of the engagement partner shall be included in the auditor's report on financial statements of public interest entities as per FRC Notification number 146 dated 21 December 2020.

(g) Auditor's signature

The audit report shall be signed by the audit engagement partner. In case of a public interest entity, the name of the firm and the engagement partner and the FRC registration number shall be mentioned in the signature panel of the audit report.

(h) Auditor's address

The report must name the location where the auditor is based.

(i) Date of the report

The date of the report is the date on which the auditor signs the report expressing an opinion on the financial statements. It must be no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence.

6.2 Key audit matters

The IAASB project on auditor's reports resulted in the issue of a new auditing standard. This standard has been adopted by the FRC as ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*. It applies to the **audits of all public interest entities** but can be applied to other audits when the auditor believes it to be necessary. The key points in this ISA are summarised below.

6.2.1 Determining key audit matters (KAMs)

Definition

Key audit matters (KAMs): Those matters, that in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. KAMs are selected from matters communicated with those charged with governance.

ISA 701 identifies the purpose of including this information as being to:

- enhance the communicative value of the auditor's report;
- provide additional information to intended users; and
- assist users in understanding significant audit matters and the judgments involved.

(ISA 701.2)

Note: The inclusion of a KAM section does not constitute a modification of the auditor's report and cannot be used as a substitute for a modified opinion. In addition, the KAM section cannot be used as a substitute for disclosures that should have been made.

ISA 701 suggests a three-step 'filtering' approach to determining what constitutes a KAM:

Step 1 The auditor starts by considering **all the matters communicated with those charged with governance**

Step 2 From these the auditor will assess which of these matters required **significant audit attention**. This process will involve taking into account areas of higher/significant risk, significant auditor/management judgment and the effect of significant events or transactions that occurred in the period

Step 3 The auditor will then select from those matters identified in Step 2 the matters which were of **most significance** in the audit

Step 3 is clearly the most important step of the process in which the auditor is required to apply judgment in evaluating the relative significance of different issues.

In making this decision the auditor would consider the following:

- Matters which resulted in significant interaction with those charged with governance
- The importance of the matter to the intended users' understanding of the financial statements as a whole
- The nature/complexity/subjectivity of selection of accounting policies
- The nature and materiality of misstatements (corrected and uncorrected)
- The nature and extent of audit effort needed to address the matter
- Whether there were issues in applying audit procedures
- Extent of related control deficiencies
- Whether the matter affected more than one area of the financial statements

(ISA 701.A27 &. A29)

6.2.2 Disclosure

Where relevant the auditor's report must include a separate section with the heading 'Key Audit Matters'. This includes an introduction followed by information about each individual KAM. The introductory material states that:

- the matters described are the matters of 'most significance'; and
- the auditor does not provide a separate opinion on these matters.

(ISA 701.11)

The description of an individual KAM would include the following:

- Why the matter was considered to be one of the most significant in the audit
- How the matter was addressed in the audit

Reference should also be made to any related disclosures in the financial statements. The following information must also be provided:

- A description of the most significant assessed risks of material misstatement
- A summary of the auditor's responses to those risks
- Key observations arising in respect to those risks

(ISA 701.13–.13-2)

The ICAEW Audit and Assurance Faculty published a report in 2017 titled '**The start of a conversation**

– The extended audit report ' to support all parties involved in this form of communication. Clearly, this process is still in its infancy, but presenting it in terms of a dialogue is intended to support the perception that it is a two-way process. The report also suggests metrics that could be used to assess the quality of this dialogue in respect of KAMs: (i) the average number of KAMs in a report; and (ii) most common topics making up KAMs.

Here is an example of how KAMs could appear, taken from the IAASB's guidance publication *Auditor Reporting – Illustrative Key Audit Matters*:

Key audit matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Goodwill

Under IFRSs, the Group is required to annually test the amount of goodwill for impairment. This annual impairment test was significant to our audit because the balance of XX as of December 31, 20X1 is material to the financial statements. In addition, management's assessment process is complex and highly judgmental and is based on assumptions, specifically [describe certain assumptions], which are affected by expected future market or economic conditions, particularly those in [name of country or geographic area].

Our audit procedures included, among others, using a valuation expert to assist us in evaluating the assumptions and methodologies used by the Group, in particular those relating to the forecasted revenue growth and profit margins for [name of business line]. We also focused on the adequacy of the Group's disclosures about those assumptions to which the outcome of the impairment test is most sensitive, that is, those that have the most significant effect on the determination of the recoverable amount of goodwill.

The Company's disclosures about goodwill are included in Note 3, which specifically explains that small changes in the key assumptions used could give rise to an impairment of the goodwill balance in the future.

Revenue recognition

The amount of revenue and profit recognized in the year on the sale of [name of product] and aftermarket services is dependent on the appropriate assessment of whether or not each long- term aftermarket contract for services is linked to or separate from the contract for sale of [name of product]. As the commercial arrangements can be complex, significant judgment is applied in selecting the accounting basis in each case. In our view, revenue recognition is significant to our audit as the Group might inappropriately account for sales of [name of product] and long-term service agreements as a single arrangement for accounting purposes and this would usually lead to revenue and profit being recognized too early because the margin in the long-term service agreement is usually higher than the margin in the [name of product] sale agreement.

Our audit procedures to address the risk of material misstatement relating to revenue recognition, which was considered to be a significant risk, included:

- Testing of controls, assisted by our own IT specialists, including, among others, those over: input of individual advertising campaigns' terms and pricing; comparison of those terms and pricing data against the related overarching contracts with advertising agencies; and linkage to viewer data; and
- Detailed analysis of revenue and the timing of its recognition based on expectations derived from our industry knowledge and external market data, following up variances from our expectations.

(Source: IAASB guidance publication, (2015) *Auditor Reporting – Illustrative Key Audit Matters*)

In very limited circumstances it may be the case that KAMs exist but cannot or should not be disclosed. These might include circumstances where law or regulation does not allow disclosure or where the adverse consequences of disclosure would outweigh the public interest benefit.

(ISA 701.14b)

It is also possible, although again very rare, that there may be no KAMs to disclose in the KAMs section. Where this is the case a KAM section is still included in the auditor's report but a statement is made that there are no KAMs to communicate. ISA 701.A58 provides the following illustration of the appropriate wording in this situation:

[Except for the matter described in the Basis for Qualified (Adverse) Opinion section or Material Uncertainty Related to Going Concern section,] We have determined that there are no [other] key audit matters to communicate in our report.

6.2.3 Interaction between descriptions of key audit matters and other elements included in the auditor's report

Where a matter results in a modified audit opinion, the matter by definition would be a KAM. However modified audit opinions must be reported in accordance with ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report* and as a result a description of the matter will be included in the 'Basis for modified opinion' paragraph and **not in the KAM section.** The KAM section must however include a reference to the basis for modified opinion paragraph.

ISA 701 also makes particular reference to going concern issues. As we have seen in section 3 of this chapter in accordance with ISA 570 if **adequate disclosure** is made in the financial statements of a material uncertainty relating to going concern, the auditor expresses an unmodified opinion but includes a separate section under the heading 'Material Uncertainty Related to Going Concern'. The matter is **not also described as a KAM**, although the KAM section should include a reference to the 'Material Uncertainty Related to Going Concern' section.

(ISA 701.15)

6.2.4 Communication with those charged with governance

The auditor is required to communicate to those charged with governance either the KAMs included in the auditor's report or the fact that there are no KAMs.

(ISA 701.17)

6.2.5 Documentation

Audit documentation must include the 'significant audit matters' from which the KAMs were then selected and the rationale for determining whether each of these is a KAM or not. Where the auditor has concluded that there are no KAMs, or that a KAM is not able to be disclosed the reasons for this should be documented.

(ISA 701.18)

6.3 Modified opinions, emphasis of matter and other matter paragraphs

6.3.1 Modifications to the audit opinion

Modifications to the audit opinion are covered by ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*.

ISA 705 requires a modified opinion when:

(a) the auditor concludes that, based on the evidence obtained, the financial statements as a whole are **not free from material misstatement**; or

(b) the auditor is **unable to obtain sufficient appropriate audit evidence** to conclude that the financial statements as a whole are free from material misstatement.

and, in the auditor's judgement, the effect of the matter is or may be **material** to the financial statements.

There are **three** types of modified opinion:

- Qualified opinion
- Disclaimer of opinion
- Adverse opinion

6.3.2 Determining the type of modification

In accordance with ISA 705 there are different types and degrees of modified opinion.

- A material misstatement (disagreement) may lead to a **qualified opinion** or an **adverse opinion**.
- An inability to obtain sufficient, appropriate evidence (limitation on scope) may lead to a **qualified opinion** or a **disclaimer of opinion**.
- The degree of modification depends on whether the auditor considers that the misstatement, or possible misstatement, is pervasive to the financial statements.

Definition

Pervasive effects: Pervasive effects on the financial statements are those that, in the auditor's judgement:

- are not confined to specific elements, accounts or items of the financial statements;
- if so confined, represent or could represent a substantial proportion of the financial statements; or
- in relation to disclosures, are fundamental to users' understanding of the financial statements.

(ISA 705.5)

The following table based on the table from ISA 705.A1 summarises the different types of modified opinion, and we will look at the detail of each of these in turn:

Nature of circumstances	Material but not pervasive	Material and pervasive
Financial statements are materially misstated (disagreement)	Qualified opinion Except for …	Adverse opinion (Auditors state that the financial statements do not give a true and fair view)
Inability to obtain sufficient, appropriate audit evidence (limitation on scope)	Qualified opinion Except for … might	Disclaimer of opinion (Auditors state they are unable to form an opinion on the truth and fairness of the financial statements as a whole)

The ISA (ISA 705.7–.9) describes these different modified opinions and the circumstances leading to them as follows.

(a) A **qualified opinion** must be expressed when the auditor concludes that an unmodified opinion cannot be expressed but that the effect of any misstatement, or the possible effect of undetected misstatements, is material but not pervasive. A qualified opinion should be expressed as being "except for the effects of the matter to which the qualification relates".

(b) A **disclaimer of opinion** must be expressed when the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements. In rare circumstances involving multiple uncertainties the auditor may issue a disclaimer even though sufficient appropriate evidence has been obtained regarding each of the individual uncertainties, due to the potential interaction of these uncertainties and their possible cumulative effect on the financial statements.

(c) An **adverse opinion** must be expressed when the auditor has obtained sufficient appropriate audit evidence and concludes that misstatements, individually or in aggregate, are both material and pervasive to the financial statements.

Basis for opinion paragraph

Where the auditor modifies the opinion on the financial statements, the title of the basis paragraph should also be modified to read 'Basis for Qualified Opinion', 'Basis for Adverse Opinion' or 'Basis for Disclaimer of Opinion' as appropriate.

Misstatement

The auditor may disagree with management about matters such as the acceptability of accounting policies selected, the method of their application, or the adequacy of disclosures in the financial statements. The ISA states that if such disagreements are material to the financial statements, the auditor should express a qualified or an adverse opinion.

See Appendix Illustrations 1 and 2.

Inability to obtain evidence

The standard identifies three circumstances where there might be an inability to obtain sufficient evidence:

(a) **Circumstances beyond the entity's control** (such as where the entity's accounting records have been destroyed).

(b) **Circumstances relating to the nature or timing of the auditor's work** (for example, when the timing of the auditor's appointment is such that the auditor is unable to observe the counting of physical inventory). It may also arise when, in the opinion of the auditor, the entity's accounting records are inadequate or when the auditor is unable to carry out an audit procedure believed to be desirable. In these circumstances, the auditor would attempt to carry out reasonable alternative procedures to obtain sufficient, appropriate audit evidence to support an unqualified opinion.

(c) A limitation on the scope of the auditor's work may sometimes be **imposed by management** (for example, when management prevents the auditor from observing the counting of physical inventory). This would constitute a limitation on scope if the auditor was unable to obtain sufficient, appropriate evidence by performing alternative procedures.

If the auditor experiences a limitation on scope after they have accepted appointment which is both material and pervasive they should consider withdrawal from the audit where it is practicable and possible under applicable law or regulation. Where this is not the case the auditor must disclaim an opinion on the financial statements.

When the limitation in the terms of a **proposed** engagement is such that the auditor believes the need to express a disclaimer of opinion exists before the appointment has been accepted, the auditor would usually not accept such a limited audit engagement, unless required by statute. Also, a statutory auditor would not accept such an audit engagement when the limitation infringes on the auditor's statutory duties.

See Appendix Illustrations 3 and 4.

6.3.3 Emphasis of matter and other matters

ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* deals with circumstances where the auditor considers it necessary to draw users' attention to important matters.

Definition

Emphasis of matter paragraph: A paragraph included in the auditor's report that refers to a matter **appropriately presented or disclosed** in the financial statements that, in the auditor's judgement, is of such importance that it is fundamental to users' understanding of the financial statements.

(ISA 706.7a)

Examples

- An uncertainty relating to the future outcome of exceptional litigation or regulatory action
- Early application of a new accounting standard that has a pervasive effect on the financial statement before its effective date
- A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position

Other ISAs specify circumstances in which it may be necessary to include an emphasis of matter paragraph for example ISA 560, *Subsequent Events* which was covered earlier in this chapter.

This paragraph must be included in a separate section of the auditor's report with an appropriate heading including the term 'Emphasis of Matter'. This section must also state that the auditor's report is not modified in this respect.

(ISA 706.9)

Note: In some circumstances matters identified as KAMs may also be fundamental to users' understanding of the financial statements. In this situation however, the matter is **not** disclosed in an emphasis of matter paragraph as well as being disclosed as a KAM. Instead the auditor must consider highlighting the importance of the matter, for example, by presenting it more prominently in the KAM section. (ISA 706.A2)

Where a matter is not determined to be a KAM but is fundamental to users' understanding an emphasis of matter paragraph would be included in the auditor's report.

(ISA 706.A3)

Definition

Other matter paragraph: A paragraph included in the auditor's report that refers to a matter **other than those presented or disclosed in the financial statements** that, in the auditor's judgement, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

(ISA 706.7b)

This paragraph must also be included as a separate section in the auditor's report headed 'Other Matter' or another appropriate heading.

Note: An 'Other Matter' paragraph would not be included where the matter has been determined to be a KAM (ISA 706.10).

An example of an emphasis of matter paragraph is contained in the **Appendix** to this chapter.

See **Illustration 5.**

Professional skills focus: Applying judgement

It's very unlikely that in an exam you will be presented with an organisation where everything runs smoothly and there are no tricky decisions to have to make. Emphasis of matter paragraphs, other matter paragraphs and key audit matters are all areas where the auditor needs to display sound judgement in how to communicate the events before them in the most effective way. Use the questions at your disposal to understand how each of these works.

6.4 Current issues

6.4.1 The act of communication

In essence, the auditor's job is straightforward. They carry out tests and inquiries and evaluate evidence received with the purpose of drawing an audit opinion. They then **communicate** that opinion, in the form of an auditor's report, as we have been discussing. This can cause problems.

The communication problem is caused by a number of different problems that can be identified under three headings, although some of the problems are broadly linked between categories. The three problematic areas are as follows:

- Understandability
- Responsibility
- Availability

6.4.2 Understandability

Although the essence of the auditor's role is simple, in practice it is surrounded by auditing standards and guidance, as it is a **technical** art. It also involves **relevant language**, or 'jargon', that non-auditors may not understand.

Communicating the audit opinion in a way that people can understand is a challenge. ISA 700 (Revised) together with ISA 701 go some way to addressing those challenges (see earlier sections).

6.4.3 Responsibility

Connected with the problem of what the audit is and what the audit opinion means is the question of what the auditors are **responsible** for. As far as the **law** is concerned, auditors have a restricted number of duties. **Professional standards** and other bodies, put other duties on auditors.

Users of financial statements, and the public, may not have a very clear perception of what the auditors are responsible for and what the audit opinion relates to, or what context it is in.

The issue of **auditor's liability** ties in here. Auditor's reports are addressed to shareholders, to whom auditors have their primary and legal responsibility. However, audited financial statements are used by significantly more people than that. Should this fact be addressed in the auditor's report?

6.4.4 Availability

The fact that a significant number of people use audited financial statements has just been mentioned. Auditor's reports are publicly available, as they are often held on **public record**. This fact alone may add to any perception that exists that auditors address their report to more than just shareholders.

The problem of availability is exacerbated by the fact that many companies publish their **financial statements** on their **website**. This means that millions of people around the world have access to the auditor's report.

This issue may cause misunderstanding:

- **Language** barriers may cause additional understandability problems.
- It may not be clear **which financial information** an auditor's report refers to.
- The auditor's report may be subject to **malicious tampering** by hackers or personnel.

If an auditor's report is published electronically, auditors lose control of the **physical positioning** of the report; that is, what it is published with. This might significantly impact on understandability and also perceived responsibility.

When financial information is available electronically, auditors must ensure that their report is not misrepresented.

Interactive question 4: Forming an audit opinion

You are an audit senior. You are nearing the end of the audit of Russell Ltd for the year ended 30 June 20X7. The financial statements show a profit before tax of £14 million (20X6: £6 million) and a statement of financial position total of £46 million (20X6: £30 million). The following points have arisen on the audit:

(1) Russell Ltd owns a number of its retail premises, which it revalues annually. This year several of its shops did rise sharply in value due to inflated property prices in their locality. Russell Ltd also capitalises refits of its shops. Four shops were refitted in the year. The total increase in assets due to refits and revaluations is £20 million. Russell Ltd does not revalue its factory premises, which are recognised in the statement of financial position at £250,000.

(2) Russell Ltd makes approximately 20% of its sales via an internet site from which it sells the products of Cairns plc. Russell Ltd earns commission of 15% on these sales. Customers place their order on the internet site and pay for goods by providing their credit card details. Once Russell Ltd has received authorisation from the credit card company the order is passed to Cairns plc. The product is then shipped directly to the customer and all product returns and credit card related issues are dealt with by Cairns plc. The total

product sales achieved through the internet site and despatched to customers in the year were £6,000,000. This amount has been recognised as revenue for the year ended 30 June 20X7.

Requirement

Comment on the matters you will consider in relation to the implications of the above points on the auditor's report of Russell Ltd.

See **Answer** at the end of this chapter.

6.5 The Auditor's Responsibilities Relating to Other Information

ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information* has been adopted in Bangladesh.

6.5.1 What is other information?

Definitions

Other information: Financial and non-financial information (**other than** financial statements and the auditor's report) included in an entity's annual report (such as summaries of key financial results, explanations of critical accounting estimates and financial measures or ratios).

Misstatement of the other information: This exists when the other information is incorrectly stated or otherwise misleading (including because it omits or obscures information necessary for a proper understanding of a matter disclosed in the other information).

(ISA 720.12 and Appendix 1)

ISA 720.2 makes it clear that the auditor does not express an opinion on the other information.

The auditor is required, however, to read the other information and do the following:

(a) Consider whether there is a material inconsistency between the other information and the financial statements

(b) Consider whether there is a material inconsistency between the other information and the auditor's knowledge obtained in the audit

(c) Respond appropriately when the auditor identifies that such a material inconsistency appears to exist, or when the auditor otherwise becomes aware that other information appears to be materially misstated

(d) Report in accordance with ISA 720

6.5.2 Access to other information

In order for the auditor to satisfy their obligations under ISA 720, timely access to other information will be required. The auditors therefore must make arrangements with the client to obtain such information **before the date of their report** where possible. Where some or all of the documents will not be available until after the date of the auditor's report the auditor must request a written representation that the information will be provided as soon as it is available.

(ISA 720.13)

6.5.3 Material inconsistency or material misstatement of other information

If, on reading the other information, the auditor identifies a **material inconsistency or becomes aware that the other information appears to be materially misstated**, the auditor must determine whether:

- The audited financial statements need to be amended
- The other information needs to be amended
- Or whether the auditor's understanding of the entity and its environment needs updating.

The auditor should seek to resolve the matter through **discussion** with those charged with governance.

If an amendment is necessary in the **audited financial statements** and the entity refuses to make the amendment, the auditor should express **a qualified or adverse opinion**.

If an amendment is necessary in the **other information obtained before the date of the auditor's report** and the entity refuses to make the amendment, the auditor shall communicate this to those charged with governance and:

(a) include in the 'Other information' section of the auditor's report a statement describing the uncorrected material misstatement; or

(b) withdraw from the engagement.

(ISA 720.18)

If a material misstatement exists in other information obtained after the date of the auditor's report the actions taken by the auditor depend on whether a correction is made. If the other information is corrected the auditors will perform additional procedures which will normally include checking that the correction has been made properly and reviewing the steps taken by management to inform parties who have already received the information.

(ISA 720.A48)

If the other information is not corrected the specific action taken would depend on the auditor's legal rights and obligations. As a result it is likely that the auditor will seek legal advice.

6.5.4 Reporting

When the auditor's report in required to include an 'Other Information' section. This must include the following:

(a) A statement that management is responsible for other information

(b) Identification of other information obtained before the date of the auditor's report (and, for the audit of a listed entity, other information, if any expected to be obtained after the date of the auditor's report)

(c) A statement that the auditor's opinion does not cover the other information and that the auditor does not express an audit opinion or any form of assurance conclusion on this (however, see section 6.5.5)

(d) A description of the auditor's responsibilities relating to reading, considering and reporting on other information

(e) When other information has been obtained before the date of the auditor's report, either:

  - a statement that the auditor has nothing to report; or
  - where there is a material uncorrected misstatement a statement that describes this.

(ISA 720.22)

6.5.5 Current issues

In December 2018, the UK FRC published 'Audit Quality Thematic Review: Other Information in the Annual Report 'to highlight the variation in approach taken by UK firms when auditing other information. This is the first time that the UK FRC has reviewed the work of auditors in this area and it complements other recent Thematic Reviews covering the quality of audit work performed in the UK. In summary, the UK FRC found that more could be done by auditors and audit committees regarding other information disclosures to inform users of financial statements adequately on non-financial and other qualitative factors.

Professional skills focus: Concluding, recommending and communicating

You have already seen from your studies that questions on the auditor's report usually require some form of conclusion to be drawn, so you must make sure you don't sit on the fence and commit to a specific course of action. This is central to the auditor's primary role of communication.

7 Other reporting responsibilities

Section overview

- Auditors may have to report on entire special purpose financial statements or simply one element of those financial statements.
- Auditors may have to report on summary financial statements.

7.1 Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks

7.1.1 Introduction

ISA 800 (Revised), *Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks* is effective for periods ending on or after 15 December 2016.

7.1.2 Overview

The ISA aims to address special considerations that are relevant to complete sets of financial statements prepared in accordance with **another comprehensive basis of accounting**.

The aim of the ISA is simply to identify additional audit requirements relating to these areas. To be clear, all other ISAs still apply to the audit engagement.

7.1.3 General considerations

- Before undertaking a special purpose audit engagement, the auditor should ensure there is agreement with the client as to the **exact nature of the engagement** and the **form and content of the report** to be issued.
- To avoid the possibility of the auditor's report being used for purposes for which it was not intended, the auditor may wish to **indicate in the report the purpose for which it is prepared and any restrictions on its distribution and use**.

7.1.4 Special purpose frameworks

In the context of the ISA, special purpose frameworks refer to accounts which are prepared in situations other than within a Companies Act statutory audit. Specific examples of special purpose frameworks given in the ISA include the following:

- **Tax basis** of accounting for a set of financial statements that accompany an entity's tax return
- **Cash receipts and payments basis** of accounting for cash flow information that an entity

may be requested to prepare for creditors

- The **financial reporting provisions established by a regulator** to meet that regulator's requirements
- The **financial reporting provisions of a contract,** such as a bond, indenture, a loan agreement and a project grant

The auditor's report in these circumstances should include an emphasis of matter that indicates the basis of accounting used or should refer to the note to the financial statements giving that information. The opinion should state whether the financial statements are prepared, in all material respects, in accordance with the identified basis of accounting.

The auditor must specifically describe the financial reporting framework as a special purpose framework in the auditor's report. The auditor must also specifically state that the audit has been carried out in accordance with ISAs, including ISA 800 and/or ISA 805.

7.1.5 Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement

ISA 805 (Revised), *Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement* relates to **individual elements of financial statements**, such as the liability for accrued benefits of a pension plan and a schedule of employee bonuses. This ISA is effective for periods ending on or after 15 December 2016.

Many financial statement items are interrelated. Therefore, when reporting on a component the auditor will not always be able to consider it in isolation and will need to examine other financial information. This will need to be considered when assessing the scope of the engagement and determining whether the audit of a single statement or single element is practicable.

The auditor's report should indicate the applicable financial reporting framework adopted or the basis of accounting used, and should state whether the component is prepared in accordance with this.

Reporting considerations

Engagements that involve reporting on a single statement or specific element **in conjunction with auditing the entity's complete set of financial statements**	• The auditor shall express a separate opinion for each. • The auditor shall ensure that management presents the single financial statement or element in such a way that it is clearly differentiated from the complete set of financial statements.
The auditor's opinion on the entity's complete set of financial statements is **modified** or includes an **emphasis of matter** or **other matter** paragraph, a material uncertainty related to going concern, communication of key audit matters or a statement describing an uncorrected material misstatement of other information	• The auditor must determine whether this will affect the opinion on the single financial statement or element.

The auditor has expressed an **adverse opinion** or **disclaimed an opinion** on the entity's complete set of financial statements	• The auditor **must not** include an unmodified opinion on a single financial statement or element that forms part of those financial statements **in the same report** (as this would contradict the adverse opinion or disclaimer on the complete set of financial statements). • The auditor **must not** express an unmodified opinion on a single financial statement of a complete set of financial statements even if the report on the single financial statement is not published with the auditor's report containing the adverse opinion or disclaimer. • The auditor may express an unmodified opinion on an element of the financial statements if: - not prohibited by law; - the opinion is published separately; and - the element does not form a major portion of the entity's complete set of financial statements.

7.1.6 Engagements to Report on Summary Financial Statements

ISA 810 , *Engagements to Report on Summary Financial Statements* was revised by the IAASB in March 2016. It has not been adopted in Bangladesh by the FRC and is effective for periods ending on or after 15 December 2016 . The key point which this ISA makes is that the auditor should **not express an opinion on the summarised financial statements** unless they have **expressed an audit opinion on the financial statements from which they have been derived**.

Reporting considerations: Form of report

Unmodified opinion on summary financial statements	Unless law specifies otherwise, the wording should be: • the accompanying summary financial statements are consistent in all material respects with the audited financial statements, in accordance with (the applied criteria); or • the accompanying summary financial statements are a fair summary of the audited financial statements, in accordance with (the applied criteria).

When the auditor's report on the audited financial statements includes a **qualified opinion**, an **emphasis of matter** or an **other matter** paragraph, a material uncertainty related to going concern, a KAM section or a statement describing an uncorrected material misstatement of the other information	If the auditor is satisfied that an unmodified opinion, as above, is appropriate for the summary financial statements, the report must: • state that the auditor's report on the audited financial statements includes a qualified opinion, an emphasis of matter or an other matter paragraph, a material uncertainty related to going concern, a KAM section or a statement describing an uncorrected material misstatement of the other information; • explain the basis for the above; and • state the effect on the summary financial statements if any.
When the auditor's report on the audited financial statements contains an **adverse opinion**, or a **disclaimer**	The auditor must: • state that the auditor's report on the audited financial statements contains an adverse opinion or disclaimer of opinion; • explain the basis for the adverse opinion or disclaimer; and • state that it is inappropriate to express an opinion on the summary financial statements.
Modified opinion on the summary financial statements	If the summary financial statements are **not** consistent in all material respects with the audited financial statements (or **not** a fair summary of the audited financial statements) and management does not agree to make changes, the auditor shall express an **adverse opinion**.

7.2 XBRL tagging of information in audited financial statements

In September 2009, HMRC announced that the Company Tax Return, including the supporting statutory accounts and tax computations, must be delivered electronically using the Inline XBRL format. XBRL stands for eXtensible Business Reporting Language. XBRL stands as a software standard crafted to enhance the communication of financial data, streamlining its compilation and sharing. Employing tags to label individual financial data components, XBRL enables programmable utilization by compatible software. Facilitating seamless data transmission between businesses, such requirements are presently absent in Bangladesh. The aim of this section is to acquaint students with this pivotal concept.

7.2.1 Audit

In the UK, Guidance for auditors is contained in *Bulletin 2010/1 XBRL Tagging of Information in Audited Financial Statements – Guidance for Auditors*.

Although HMRC is requiring financial statements supporting a company's tax return to be transmitted using iXBRL, there is no requirement for an audit of data or of the XBRL tagging. The Bulletin states that ISAs do not impose a general requirement on the auditor to check XBRL tagging of financial statements as part of the audit. Furthermore, because the XBRL tagging is simply a machine-readable rendering of the data within the financial statements, rather than a discrete document, it does not constitute 'other information' either.

While the auditor does not provide assurance as to the accuracy of the tagging, audit clients may request non-audit services, including the following:

- Performing the tagging exercise
- Undertaking an agreed-upon procedures engagement
- Providing advice on the selection of individual tags
- Supplying accounts preparation software that automates the tagging
- Training management in XBRL tagging

If this type of service is provided, ethical issues must be considered.

In December 2017, the UK FRC's Financial Reporting Lab published *Deep-dive: Digital future of corporate reporting* suggesting that more still needs to be done to unlock the potential of XBRL.

8 Appendix (Illustrations)

Note: As per ISA 705, illustrations 1–4 in this Appendix illustrate the requirements of the ISAs .

Illustration 1

Qualified opinion – Material misstatement of the financial statements Qualified opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies. In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the accompanying financial statements give a true and fair view of the financial position of the Company as at December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

Basis for qualified opinion

The company's inventories are carried in the statement of financial position at xxx. Management has not stated the inventories at the lower of cost and net realisable value but has stated them solely at cost, which constitutes a departure from IFRSs. The Company's records indicate that, had management stated the inventories at the lower of cost and net realisable value, an amount of xxx would have been required to write the inventories down to their net realisable value. Accordingly cost of sales would have increased by xxx, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

(Source: Illustration 1 (extract) ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*)

Illustration 2

Adverse opinion. Material misstatement of the consolidated financial statements Adverse

opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at 31 December 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion section of our report, the accompanying consolidated financial statements do not give a true and fair view of the consolidated financial position of the Group as at December 31, 20X1, and of its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

Basis for adverse opinion

As explained in Note X, the Group has not consolidated subsidiary XYZ Company that the Group acquired during 20X1 because it has not yet been able to determine the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis. Under IFRSs, the Company should have consolidated this subsidiary and accounted for the acquisition based on provisional amounts. Had XYZ Company been consolidated, many elements in the accompanying consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Consolidated Financial Statements section of our report. We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the consolidated financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse opinion.

(Source: Illustration 2 (extract) ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*)

Illustration 3

Qualified opinion – Due to auditor's inability to obtain sufficient audit evidence regarding a foreign associate

Qualified opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion section of our report, the accompanying consolidated financial statements give a true and fair view of the financial position of the Group as at December 31, 20X1, and of its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

Basis for qualified opinion

The Group's investment in XYZ Company, a foreign associate acquired during the year and accounted for by the equity method, is carried at xxx on the consolidated statement of financial position at December 31, 20X1, and ABC's share of XYZ's net income of xxx is included in ABC's income for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC's investment in XYZ as at December 31, 20X1, and ABC's share of XYZ's net income as we were denied access to the financial information, management, and the auditors of XYZ. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Consolidated Financial Statements section of our report. We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the consolidated financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

(Source: Illustration 3 (extract) ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*)

Illustration 4

Disclaimer of opinion. Due to the auditor's inability to obtain sufficient appropriate audit evidence about a single element of the consolidated financial statements

Disclaimer of opinion

We were engaged to audit the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

We do not express an opinion on the accompanying consolidated financial statements of the Group. Because of the significance of the matter described in the Basis for Disclaimer of Opinion section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these consolidated financial statements.

Basis for Disclaimer of opinion

The Group's investment in its joint venture XYZ Company is carried at xxx on the Group's consolidated statement of financial position, which represents over 90% of the Group's net assets as at December 31, 20X1. We were not allowed access to the management and the auditors of XYZ Company, including XYZ Company's auditor's audit documentation. As a result, we were unable to determine whether any adjustments were necessary in respect of the Group's proportional share of XYZ Company's assets that it controls jointly, its proportional share of XYZ Company's liabilities for which it is jointly responsible, its proportional share of XYZ's income and expenses for the year, and the elements making up the consolidated statement of changes in equity and consolidated cash flow statement.

(Source: Illustration 4 (extract) ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*)

Illustration 5

Emphasis of matter paragraph

We draw attention to note X of the financial statements, which describes the effects of a fire in the Company's production facilities. Our opinion is not modified in respect of this matter.

(Source: Appendix 4 (extract) ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*)

Note: This paragraph is inserted after the conclusions relating to going concern section.

Illustration 6

Unqualified opinion. Material uncertainty that may cast significant doubt about the company's ability to continue as a going concern. Disclosure is adequate

Opinion

In our opinion the financial statements:

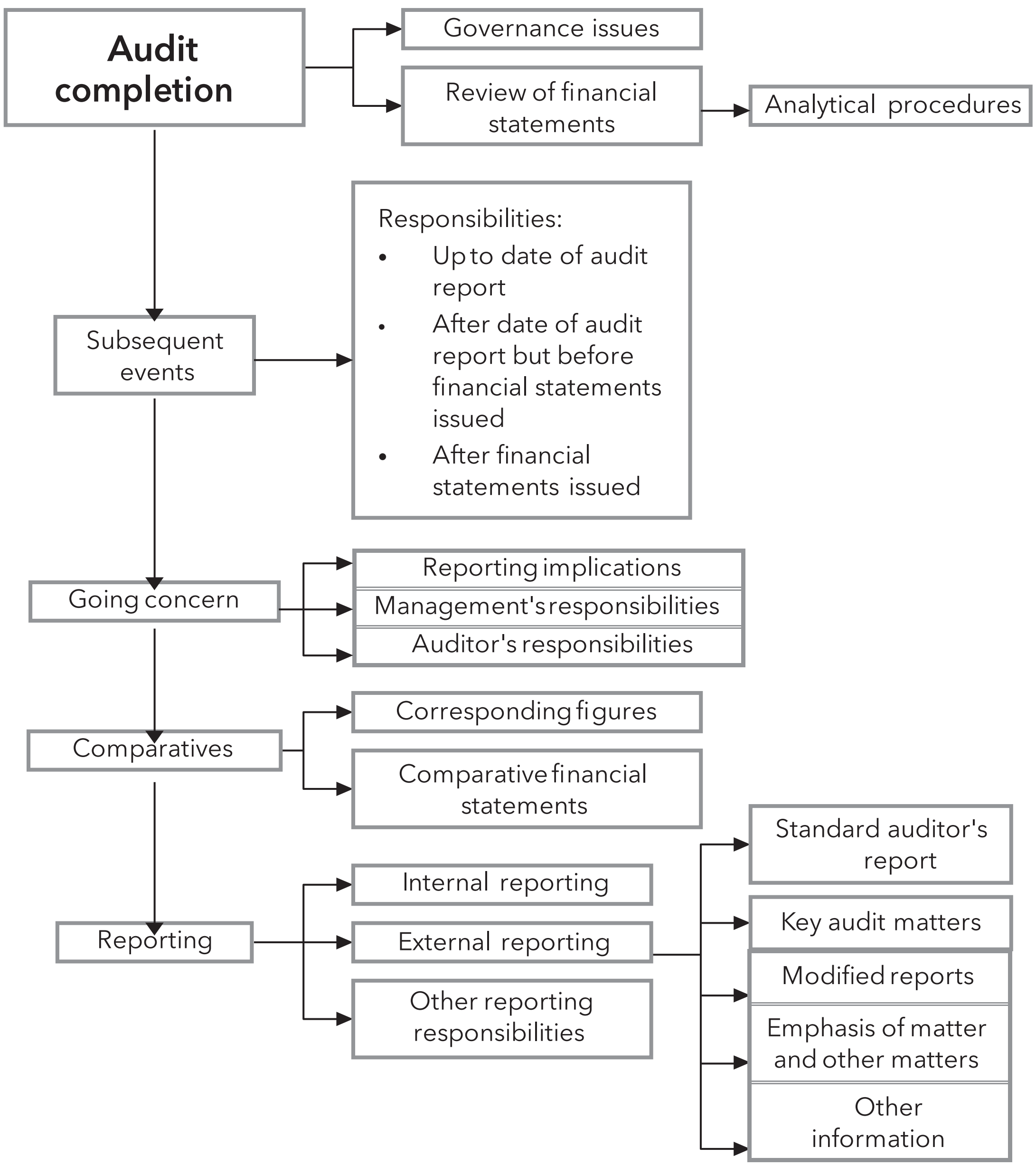
- Give a true and fair view of the state of the company's affairs as at [*date*] and of its [profit/loss] for the year then ended;
- Have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- Have been prepared in accordance with the requirements of the Companies Act 2006.

Material uncertainty related to going concern

We draw attention to note [X] in the financial statements, which indicates that [brief description of events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern]. As stated in note [X], these events or conditions, along with the other matters as set forth in note [X], indicate that a material uncertainty exists that may cast significant doubt on the company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

(Source: Appendix 4 (extract) UK FRC, *Bulletin: Illustrative Auditor's Reports on United Kingdom Private Sector Financial Statements*)

Summary



Audit completion
Governance issues
Review of financial statements
Analytical procedures
Subsequent events
Responsibilities:
• Up to date of audit report
• After date of audit report but before financial statements issued
• After financial statements issued
Going concern
Reporting implications
Management's responsibilities
Auditor's responsibilities
Comparatives
Corresponding figures
Comparative financial statements
Reporting
Internal reporting
External reporting
Other reporting responsibilities
Standard auditor's report
Key audit matters
Modified reports
Emphasis of matter and other matters
Other information

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Do you know the various stages of the audit completion process and can you find the necessary standards in your open book?
2.	Can you distinguish between the various responsibilities that the auditor needs to fulfil at different stages of the audit, including right up to the date of the AGM?
3.	Do you know how to identify and communicate the most appropriate conclusion regarding the audited entity's going concern status?
4.	Can you explain the auditor's responsibilities for dealing with comparatives and written representations?
5.	Do you know how to structure the auditor's report, whether it is modified or requires some form of modification?
6.	Can you explain when you would apply the various modifications to the audit opinion and what form they would take?
7.	Can you explain the auditor's responsibilities regarding other engagements (for example, summary financial statements)?
8.	Can you find the various modifications to the auditor's report in the auditing standards open book?

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Branch plc	This will allow you to critically appraise extracts from a draft auditor's report in line with your knowledge of how it should look and the facts presented in the scenario.
SafeAsHouses plc	This question is a typical example of being 'thrown in at the deep end' on a problematic engagement that is nearing its completion. How should you respond?

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios that will help you improve your knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
UHN requirement (3)	Although the question asks for key areas of audit risk, you will need to consider the going concern status of UHN and the impact (if any) that this could have on the auditor's report and opinion.
Tawkcom	The question asks for an overview of the auditor's responsibilities under ISA 701 on key audit matters – do you know what these are?
Biltmore requirement (3)	You need to be able to discuss impact on the auditor's report if necessary changes are not made to the draft financial statements.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving on to the next chapter.

Technical reference

1 **ISA 260**

- Auditor's objectives – **ISA 260.9**
- Who auditor should communicate to – **ISA 260.11–.13**
- Matters to be communicated to those charged with governance – **ISA 260.14-.16**
- Timing of communications – **ISA 260.21**
- Form of communications – **ISA 260.19–.20**

2 **ISA 265**

- Identifying significant deficiencies – **ISA 265.A5–.A7**
- Written communication – **ISA 265.11**

3 **ISA 450**

- Evaluating the effects of misstatements – **ISA 450.10–.11**

4 **ISA 520**

- Analytical procedures at the end of the audit – **ISA 520.6,.A17–.A19**
- Investigating unusual items – **ISA 520.7**

5 **ISA 560**

- Auditor's duty – **ISA 560.6**
- Audit procedures for obtaining audit evidence – **ISA 560.7–.9**
- Events after date of auditor's report but before date financial statements issued – **ISA 560.10–.13**
- Events after date financial statements have been issued – **ISA (UK) 560.14–.17**

6 **ISA 570**

- Auditor's responsibility – **ISA 570.6–.7**
- Auditor's objectives – **ISA 570.9**
- Indicators of going concern problems – **ISA 570.A3**
- Audit procedures – **ISA 570.16, A16**
- Evaluating management assessment of going concern – **ISA 570.12–.14**
- Audit procedures – period beyond management's assessment – **ISA 570.15**
- Audit conclusions and reporting – **ISA 570.17–.24**

7 **ISA 580**

- Definition – **ISA 580.7**
- Acknowledgement of management responsibility – **ISA 580.10–.12**
- Representations by management as audit evidence – **ISA 580.13**
- Documentation of representations – **ISA 580.15**
- Elements of a representation letter – **ISA 580 Appendix 2**
- Actions if management refuse to provide written representations – **ISA 580.19**

8 **ISA 700**

- Auditor's objective – **ISA 700.6**
- Elements of a standard auditor's report – **ISA 700.21–.49**

9 **ISA 701**

- Determining key audit matters – **ISA 701.9–10**
- Communicating key audit matters – **ISA 701.11–17**

10 **ISA 705**

- Auditor's objective – **ISA 705.4**
- Circumstances when modifications are required – **ISA 705.6**
- Types of modification – **ISA 705.7–10, A1**

11 **ISA 706**

- Emphasis of matter paragraphs – **ISA 706.8–.9**
- Other matter paragraphs – **ISA 706.10–.11**

12 **ISA 710**

- Reporting responsibilities – **ISA 710.3**
- Overview of audit procedures – **ISA 710.7–.9**
- Corresponding figures – reporting – **ISA 710.10–.14**
- Comparative financial statements – reporting – **ISA 710.15–.16**

13 **ISA 720**

- Auditor's objective – **ISA 720.11**
- Action when a material misstatement of the other information exists – **ISA 720.17–.19**
- Action on identifying a material misstatement in the financial statements – **ISA 720.20**
- Reporting – **ISA 720.21–.24**

14 **ISA 800**

- Reports on financial statements prepared in accordance with a special purpose framework – **ISA 800.11–.14 & Appendix**

15 **ISA 805**

- Reports on a single financial statement or specific element of a financial statement – **ISA 805.11–.17 & Appendix**

16 **ISA 810 (Revised)**

- Reports on summary financial statements – **ISA 810.16–.21**

17 **Bulletin: Illustrative auditor's reports on United Kingdom private sector financial statements**

UK FRC (2021). *Bulletin: Illustrative Auditor's Reports on United Kingdom Private Sector Financial Statements* [Online]. Available from: https://www.frc.org.uk/getattachment/7a8874ec-a22d-422b- a0fd-81c7493519ab/Bulletin-Illustrative-Statutory-Auditor-s-Reports-20210823.pdf [Accessed: 27 May 2022]

Self-test questions

Answer the following questions.

1 Branch plc

You are an audit partner. Your firm carries out the audit of Branch plc, a listed company. Because the company is listed, you have been asked to perform a second partner review of the audit file for the year ended 30 June 20X7 before the audit opinion is finalised. Reported profit before tax is £1.65 million and the statement of financial position total is £7.6 million.

You have read the following notes from the audit file:

"Earnings per share

The company has disclosed both basic and diluted earnings per share. The diluted earnings per share has been incorrectly calculated because the share options held by a director were not included in the calculations. Disclosed diluted earnings per share are 22.9p. Had the share options held by the director been included, this figure would have been 22.4p. This difference is immaterial.

Financial performance statement

The directors have currently not amended certain financial performance ratios in this statement to reflect the changes made to the financial statements as a result of the auditor's work. The difference between the reported ratios and the correct ratios is minimal.

Opinion

We recommend that an unmodified audit opinion be issued."

You have noted that there is no evidence on the audit file that the corporate governance statement to be issued as part of the annual report has been reviewed by the audit team. You are aware that the company does not have an audit committee.

You are also aware that the director exercised his share options last week.

Requirement

Comment on the suitability of the proposed audit opinion and other matters arising in the light of your review. Your comments should include an indication of what form the auditor's report should take.

2 SafeAsHouses plc

SafeAsHouses plc (SAH) was incorporated and commenced trading on 1 June 20X0 to retail small household electronics products via free magazines inserted into newspapers. It has established a presence in the market, but the early years of business have been a struggle with low profitability as it has sought to create market share. On 1 June 20X2, it set up a 100% owned subsidiary, eSAH, with a view to redirecting the business to internet-based sales in the hope of reducing printing and physical distribution costs of its free magazine. SAH plans to obtain an AIM listing in the near future.

Your firm acts as auditors to both companies and you have recently been drafted into the audit because the existing senior has been taken ill. **Exhibit 1** comprises draft statements of financial position and notes for both companies. **Exhibit 2** comprises audit file notes prepared by the previous audit senior.

The audit manager has asked you to take over the detailed audit work and to identify for her in a briefing note those issues arising in the work to date that are likely to be problematic. Given the late stage of the audit, and the consequent delays because of audit staff sickness, only the major issues are to be highlighted in your briefing note to the manager. The audit manager is concerned that, because the FD is new, the retention of the audit is potentially at risk and that there should be no further delay in the audit. The FD is pressing for these matters to be finalised and the accounts to be signed quickly.

Requirement

Prepare the briefing note as requested.

Exhibit 1: Draft statements of financial position

The draft statements of financial position of SAH (parent company only) and eSAH at 31 May 20X3 are as follows.

		SAH		eSAH
	£'000	**£'000**	**£'000**	**£'000**
Non-current assets at cost		1,895		408
Less depreciation		(400)		(25)
		1,495		383
Current assets				
Inventories	422		–	
Receivables	550		225	
Bank			5	
	972		230	
Current liabilities	(662)		(313)	
Net current assets/(liabilities)		310		(83)
		1,805		300
Non-current liabilities				
8% debentures		(1,000)		
		805		300
Financed by				
Issued ordinary share capital		200		300
Share premium account		100		–
Retained earnings		505		
		805		300

Additional information

(1) Current liabilities

	SAH	eSAH
	£'000	**£'000**
Bank overdraft	92	–
Trade payables	430	300
Other payables	40	–
Accruals	100	13
	662	313

(2) Property in SAH had been revalued during the year. The revaluation amounted to £0.5 million.

(3) Debentures were issued at par on 1 June 20X0 and are due for redemption at par on 31 December 20X4.

Exhibit 2: Audit file notes

(1) eSAH has received £120,000 as a payment on account from a customer on 27 May 20X3 for delivery of goods to the customer by SAH in the following months. eSAH has a confirmed contract for this and has recorded the amount in revenue for the year.

(2) eSAH has capitalised software development costs to the amount of £408,000 during the year. There are no specific details as yet, but it appears to relate almost entirely to the development of new e-based sales systems. £186,000 of the capitalised amount related to computers and consulting support staff time bought and brought in specifically to help test the new system. eSAH is adopting its standard five-year, straight-line depreciation policy with respect to the £408,000.

(3) I have gathered together some data relating to SAH before performing analytical procedures, but have yet to get around to doing it. The relevant data is:

Year end May	**20X1**	**20X2**	**20X3**
Revenue (£'000)	500	1,140	990
Gross profit margins (%)	22	19	17
Profit/(loss) retained in the year (£'000)	2	45	(42)

I understand eSAH's provisional revenue to the year end 31 May 20X3 to be about £500,000, and gross profitability was at 10%. Inventory has remained constant during the year ended 31 May 20X3 in SAH.

(4) SAH is planning to pay a dividend for the first time this year of about £50,000. This has yet to be finalised and has not been provided for in the financial statements. The FD said he would get back to me once the figure has been finalised.

(5) The FD has suggested that the format of the business of eSAH is completely different from that of SAH and is insisting on not consolidating the results of eSAH on the grounds that it would undermine a true and fair view of the financial statements.

There are some debt covenants relating to the debenture (in SAH) of which we should be aware. I have not done any work on these, as yet.

- Net current assets are to remain positive.
- Overdraft balances are to be no more than £150,000 at all times.
- Receivables days and payable days are not to exceed 180 days each. Calculations to be based on year-end figures.
- Bank consent is required for any significant changes in the structure of the business.
- I understand that a breach of any of these conditions converts the debenture into a loan repayable on demand.

When eSAH was incorporated, bank consent was obtained in accordance with the covenants. Consent was obtained on the basis that the covenants would now apply on a consolidated basis.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

Implications

(1) Accounting treatment

(a) The accounting treatment of the oil spill depends on when the event (ie, the oil spill) took place.

(b) If the oil spill took place before the financial statements were authorised for issue the spill is an event after the reporting period. The key question then is whether it should be treated as an adjusting or non-adjusting event in accordance with IAS 10.

(c) Although the spill has only come to light on 1 April, it is possible that the leak was present at the reporting date but was not detected at this time. If this were the case, then the event would be an adjusting event and the financial statements should include a provision for the costs of rectifying the damage, including that caused to the environment. If it can be demonstrated that the leak occurred after the year end and that the effects are material, which is probable in this case, the nature of the event and an estimate of the financial effect should be disclosed.

(d) If the leak took place after 28 March ie, when the financial statements were authorised for issue, the event would not be recognised in the financial statements for 20X7 but would be recognised in 20X8.

(e) It is likely that expert evidence would need to be sought to determine how the leak has occurred and therefore to estimate when the leak might have started.

(2) Auditor's responsibility

(a) Once the auditor's report has been signed, the auditor does not have any responsibility to perform audit procedures regarding subsequent events. However, the fact that the oil spill is revealed so soon after the signing of the auditor's report may call into question whether the directors were attempting to conceal information and avoid a provision being made in the current year financial statements. It also calls into question whether all other relevant information has been given to the auditors up to this date.

(b) As the financial statements have not been issued, the auditor should consider the need to amend the financial statements. This will depend on the application of IAS 10 as described above. If the financial statements are amended to provide for an adjusting event or disclose a non-adjusting event, additional audit procedures will be required and a new auditor's report would be issued.

Answer to Interactive question 2

2.1 Circumstances/concern

Circumstances	Why cause for concern?
Fall in gross profit % achieved	While the fall in absolute revenue has been explained the fall in gross profit margin is more serious.
	This will continue to be a problem, as expenses seem constant and interest costs are growing.

Circumstances	Why cause for concern?
	This will make a future return to profitability difficult.
Losses £249,000	Such levels of losses by comparison to 20X4 profits will make negotiations with the bank difficult, especially with the loss of a major customer.
Increased receivables balance and increased ageing 20X4 74.8 days 20X5 96.7 days	Worsening debt collection is bad news when the company is making losses and has a deteriorating liquidity position.
	The increase in average debt collection period may be due to an irrecoverable receivable on the account of the major customer lost in the year.
	An irrecoverable receivable write-off would cause much increased losses.
Worsening liquidity ratio 20X4 1.03 20X5 0.87	This is a significant fall which will worsen further if an allowance for irrecoverable receivables is required.
	The company has loan and lease commitments which possibly may not be met.
Increasing reliance on short-term finance	This does not secure the future.

Summary – If the company is not a going concern the financial statements would be truer and fairer if prepared on a break-up basis. Material adjustments may then be required to the financial statements.

2.2 Audit procedures

- Analyse post-reporting date sale proceeds for non-current assets, inventory, cash received from customers.
- Review the debt ageing and cash recovery lists. Ask directors if outstanding amounts from lost customer are recoverable.
- Discuss the optimistic view of likely future contracts with the MD. Orders in the post-reporting date period should be reviewed to see if they substantiate his opinion.
- Obtain his opinion about future contracts in a written representation letter.
- Review bank/loan records to assess the extent to which the company has met its loan and lease commitments in the post-reporting date period.
- Review sales orders/sales ledger for evidence of additional lost custom in post-reporting date period.
- Obtain cash flow and profit forecasts:
  - Discuss assumptions with the directors
  - Perform sensitivity analysis flexing the key assumptions ie, interest rates, date of payment of payables and receipts from customers
- Check all commitments have been cleared in accordance with legal agreements:
  - Agree budgets to any actual results achieved in the post-reporting date period
  - Assess reasonableness of assumptions in the light of the success of the achievement of the company's budgets set for 20X5. Discuss with the directors any targets not achieved

  - Reperform calculations
  - Ensure future budgeted profits are expected to meet likely interest charges
- Review bank records to ensure that the company is operating within its overdraft facility in the post-reporting date period. Review bank certificate for terms and conditions of the facility. Review bank correspondence for any suggestion the bank is concerned about its current position.
- Ask management whether the new vehicle fleet is attracting new contracts as anticipated. Scrutinise any new contracts obtained and check improved gross profit margins will be achieved.
- Obtain written representation as to the likelihood of the company operating for 12 months from the date of approval of the financial statements.

Answer to Interactive question 3

Matters

(1) I would expect to see this referred to in a written representation letter. Appendix 1 to ISA 580 cross refers to the requirement in ISA 560, *Subsequent Events* that management should inform auditors of relevant subsequent events.

(2) This should not appear on a written representation letter, even though management opinion is involved. This indicates an incorrect accounting treatment which the auditors should be in disagreement with the directors over.

(3) This should not appear on a written representation letter, as there should be sufficient alternative evidence for this matter. The auditor should be able to obtain registered information about Subsidiary from the companies' registrar.

(4) This should not appear on a written representation letter. The auditors should be able to obtain evidence from Leaf Oil that the inventory belongs to them.

Answer to Interactive question 4

Matters

(1) Non-current assets

There are two issues here. The first is whether Russell Ltd's policy of revaluations is correct and the second is whether Russell Ltd should capitalise refit costs.

The most important thing to consider is materiality, as only material items will affect the audit opinion. The revaluations and refit total is material to the statement of financial position. It is possible that any revaluation of the factory premises would also be material.

(a) Revaluation policy

Per IAS 16, non-current assets may be held at cost or valuation. Where a company applies a revaluation policy, IAS 16 requires that all revaluations are made with sufficient regularity that the carrying amount does not vary materially from that which would be determined if fair value were used. Russell Ltd revalues annually, so meets the latter requirement.

Russell Ltd revalues property and IAS 16 requires that all items in the same class of assets be revalued, so the question arises as to whether it should also revalue the factory. This might have a material effect on the statement of financial position.

IAS 16 states that a 'class' of property, plant and equipment is a grouping of assets of a similar nature and use in an entity's operations. Although the IAS implies that buildings comprise one class, in this case the nature and use of the two kinds of building are quite distinct. Therefore creating two classes (retail premises and manufacturing premises) would appear reasonable.

(b) Refits

Assets should be held at cost or valuation as discussed above. However, in some cases, IAS 16 allows the cost of refits to be added to the original cost of the asset. This is when it is probable that future economic benefits in excess of the originally assessed standard of performance of the existing asset will flow to the entity. A retail shop will be subject to refitting and this refitting may enhance its value. However, it is possible in a shop that such refitting might be better classified as expenditure on fixtures and fittings. Russell Ltd's policy should be consistent and comparable so, if they have followed a policy of capitalising refits into the cost of the shop in the past, this seems reasonable.

Conclusion

The issues relating to non-current assets were material and could have affected the auditor's report. However, having considered the issues, it appears that there are no material misstatements relating to these issues. As there appears to have been no problem in obtaining sufficient appropriate evidence in relation to non-current assets, the audit opinion would be unmodified in relation to these issues.

(2) Revenue recognition

The key question is the nature of the revenue earned by Russell Ltd on the internet sales. Russell Ltd is acting as an agent for Cairns plc. At no point do the risks and rewards of ownership of the goods sold on the internet pass to Russell Ltd. This is evidenced by the fact that goods are sent directly to the customer by Cairns plc and they are responsible for all after-sales issues. The revenue earned by Russell Ltd is therefore the commission on sales generated rather than the sales price of the goods sold. Equally there will be no recognition of cost of sales or inventory in respect of these items.

Therefore the current treatment in the financial statements is incorrect.

In accordance with IFRS 15, *Revenue from Contracts with Customers* commission received by a party acting as an agent should be recognised as earned. As Russell Ltd has no further obligations once the initial transaction has been undertaken the commission should be recognised at this time.

Commission of approximately £900,000 should be recognised (£6,000,000 × 15%). An additional adjustment may be required in respect of sales made not despatched. The £6,000,000 trading revenue should be eliminated with any associated costs of sale and inventory. These amounts are likely to be material to the financial statements.

Conclusion

The financial statements should be revised, as they do not comply with IFRS 15. If management refuse to adjust the financial statements the auditor will need to qualify the audit opinion on the grounds of a misstatement (disagreement) which is material but not pervasive.

Answers to Self-test questions

1 Branch plc

Earnings per share

The problem in the EPS calculation relates to share options held by a director. As they are held by a director, it is unlikely that they are immaterial, as matters relating to directors are generally considered to be material by their nature. The fact that EPS is a key shareholder ratio which is therefore likely to be material in nature to the shareholders should also be considered.

As the incorrect EPS calculation is therefore material to the financial statements, the audit opinion should be modified in this respect, unless the directors agree to amend the EPS figure. This would be a qualified opinion using the term 'except for' on the grounds of material misstatement (disagreement with the accounting treatment).

Share options

The share options have not been included in the EPS calculations. The auditors must ensure that the share options have been correctly disclosed in information relating to the director in both the financial statements and the other information, and that these disclosures are consistent with each other. If proper disclosures have not been made, the auditor will have to modify the audit opinion due to lack of disclosure in this area which also represents a material misstatement.

Exercise of share options

The fact that the director has exercised his share options after the year end does not require disclosure in the financial statements. However, it is likely that he has exercised them as part of a new share issue by the company and, if so, the share issue would be a non-adjusting event after the reporting period that would require disclosure in the financial statements. We should check if this is the case and, if so, whether it has been disclosed. Non-disclosure would be further grounds for opinion modification as a material misstatement.

Financial performance statement

The financial performance statement forms part of the other information that the auditor is required to review under ISA 720. The auditor's report would include an 'Other Information' section in accordance with this standard. The ISA states that the auditors should seek to rectify any apparent misstatements in this information. The ratio figures are misstated, and the auditor should encourage the directors to correct them, regardless of the negligible difference.

The ISA refers to material items. The ratios will be of interest to shareholders, being investor information, and this fact may make them material by their nature. However, as the difference is negligible in terms of value, on balance, the difference is probably not sufficiently material for the auditors to make any specific reference to this in their auditor's report.

Corporate governance statement

For the company to meet stock exchange requirements, the auditors must review the corporate governance statement. For our own purposes, we should document that we have done so. As having an audit committee is a requirement of the Corporate Governance Code and the company does not have one, the corporate governance statement should explain why the company does not comply with the Code in this respect.

We would not modify our audit opinion over the corporate governance statement, although we would make reference to it in the 'Other Information' section, if we do not feel the disclosure is sufficient in respect of the non-compliance with the requirement to have an audit committee.

The audit opinion would not be modified in this respect. We are also required to report by exception if we have identified information that is:

- inconsistent with the information in the audited financial statements; or
- materially misstated based on the knowledge acquired by the auditor in the course of the audit.

Overall conclusion

None of the matters discussed above, either singly or seen together, are pervasive to the financial statements. The auditor's report should be modified on the material matter of the incorrect EPS calculation and the inadequate disclosures on EPS (and possibly the undisclosed share issue as well) by means of a qualified opinion and a basis section that explains this qualified opinion. We should also review the corporate governance statement: if the statement does not adequately address the issue of the company not having an audit committee, we will need to address this in the 'Other Information' of our report. Our audit opinion will not be modified in this respect.

2 SafeAsHouses plc

BRIEFING NOTES TO MANAGER

To Audit Manager **From** Audit Senior **Date** July 20X3

Client SafeAsHouses (hereafter SAH) and eSAH

Subject Major issues arising in audit work performed to date

There are a host of issues that need to be addressed. Some are important, and these are those I have highlighted for your attention.

While there may now be some urgency with respect to completing the audit it is not acceptable for us to be rushed in forming our judgement. This creates a threat to our objectivity through possible intimidation.

Incorrect financial statements

The financial statements are incorrectly stated for SAH. There is no revaluation reserve and it seems, after looking at the retained earnings in the analytical procedures, that the revaluation has been credited to profit or loss. Retained earnings should therefore be £5,000 and the revaluation reserve balance should be £500,000. (The revaluation would also be recognised as other comprehensive income in the statement of profit or loss and other comprehensive income.) The implication of this is that the company has insufficient distributable reserves to pay the proposed dividend. There also appears to be little cash to pay any dividend given the overdraft in SAH.

The intention not to consolidate the 100% subsidiary is unlikely to be allowed. IFRS 10, *Consolidated Financial Statements* does not allow exclusion of a subsidiary from consolidation on the basis of differing activities.

The company does not appear to have established a sinking fund for the redemption of the debenture. There is not enough cash in the financial statements to approach the figure required and the profitability of SAH is not sufficient to generate the amount required in the months remaining. eSAH does not appear to be generating any cash at all. Nevertheless, the company appears to have had or raised £300,000 to launch eSAH.

Moreover, in SAH, revenue and profit margins have been falling since 20X1. We will need to ascertain why this has happened and consider any explanations received in conjunction with available forecast figures.

I am seriously concerned at the levels of receivables and payables in both companies. Not enough cash is coming into the businesses and not enough, it appears, is being used to pay the payables. There is a solvency issue pending which may well be crystallised when one considers the debt covenants.

Net current assets

These stand at £310,000 for SAH and are clearly positive, which satisfies the constraint in place from the debt covenant. However, there are some issues in eSAH that indicate that its net current assets figures (already negative) may have to be further adjusted downward.

(1) The treatment of the payment on account of £120,000 is incorrect and does not accord with prudent revenue recognition rules. The payment should not have been taken to revenue, but credited to an account in short-term payables. This adjustment will reduce net current assets to (£203,000).

(2) This means that the provisional revenue figure for eSAH of £500,000 should be reduced by £120,000 to £380,000. There is also an intra-group element that requires adjustment in that SAH still presumably holds the inventory to which the amount of £120,000 relates.

(3) In general, the inventory figure in SAH looks large and we will have to prepare an audit programme that challenges this figure in order to establish its accuracy. Given its central role in relation to the covenants, this will be important.

Other issues

(1) The development costs of the software seem to be correctly treated under IAS 38, *Intangible Assets* in that an intangible asset may be recognised as arising from development (or from the development phase of an internal project) if the following can be demonstrated.

  (a) The technical feasibility of completing the intangible asset so that it will be available for use or sale.

  (b) The entity's intention to complete the intangible asset and use or sell it.

  (c) Its ability to use or sell the intangible asset.

  This would also appear to relate to the testing costs since they meet the criteria of development activities under the standard ('the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services', para 59).

  More generally, the testing costs of £186,000 look substantial in relation to the overall £408,000 spent. This may have indicated some problems with the software. We should establish why the testing costs were so high and, if there were problems, obtain assurance of their resolution.

(2) The depreciation provision in eSAH's accounts does not seem to accord with its stated policy. They have charged only £25,000 out of a maximum of £81,600 (£408,000 ÷ 5). This would imply a charge only relating to 3.6 months of the year. We will need to ascertain what the depreciation policy is and exactly what capitalised costs have been incurred.

(3) I am suspicious that eSAH has made a nil profit in the year. It looks too coincidental and may have been the result of an arbitrary calculation on, say, depreciation with which I have some doubts anyway.

(4) The investment in the subsidiary eSAH has not been separately presented in SAH's accounts.

£300,000 will need to be recorded as a non-current asset investment once it has been identified where the incorrect debit has been recorded (possibly in the 'non-current assets' total figure).

(5) Overdraft. Unless we see a cash flow forecast demonstrating a dramatic improvement I cannot see how breaching the overdraft condition can be avoided. Two forces are at work in relation to this. First, the debenture interest at 8% suggests a repayment schedule of £130,000 per annum. Allied to significant investment in the subsidiary, cash flow may well be strained in the forthcoming year. Second, unless a refinancing package is agreed, I cannot see how the company can redeem its debenture. I cannot see any course of action at this stage other than to require disclosures on the grounds of going concern.

Receivable and payable days

I have calculated these on a consolidated basis. The relevant figures are

Receivables: (550 + 225)/(990 + (500 – 120)) × 365 = 206 days (assuming revenues are all on credit)

With inventory remaining constant in SAH (and no inventory values in eSAH), then cost of sales is equivalent to purchases. Assuming these are all on credit then

Trade payables: (430 + 300)/((990 × 83%) + ((500 – 120) × 90%)) × 365 = 229 days

The covenant is exceeded. Once this is reported, the debenture holders will be able to enforce the conversion of the debenture into a loan repayable on demand.

I consider it highly likely that the company SAH will become insolvent. It will then be up to the debenture holders to assess if a reorganisation plan is viable. In particular we will need to do the following:

- See and investigate what projections are available for SAH with a view to considering the viability of the business.
- These projections will have implications for the plans for a listing in the near future which look too ambitious as there is likely to be too much uncertainty for the business to be floated successfully.
- Assess if there are any refinancing arrangements in place or proposed that would underpin the survival of the company.
- Look to correspondence with financiers to ascertain evidence of refinancing or a relaxation of the covenants.

Chapter 9

Reporting financial performance

Introduction

Learning outcomes

- Explain how different methods of recognising and measuring assets and liabilities can affect reported financial performance
- Explain and appraise accounting standards that relate to reporting performance: in respect of presentation of financial statements; revenue; operating segments; continuing and discontinued operations; EPS; interim reporting
- Formulate and evaluate accounting and reporting policies for single entities and groups of varying sizes and in a variety of industries
- Calculate and disclose, from financial and other qualitative data, the amounts to be included in an entity's financial statements according to legal requirements, applicable financial reporting standards and accounting and reporting policies
- Appraise the significance of inconsistencies and omissions in reported information in evaluating performance
- Compare the performance and position of different entities allowing for inconsistencies in the recognition and measurement criteria in the financial statement information provided
- Make adjustments to reported earnings in order to determine underlying earnings and compare the performance of an entity over time
- Demonstrate and explain, in the application of audit procedures, how relevant ISAs affect audit risk and the evaluation of audit evidence

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
1	**IAS 1, *Presentation of Financial Statements*** IAS 1 forms the basis of financial reporting, setting out the formats of the financial statements and their structure and content.	**Approach** This section will be largely revision from your earlier studies. However, it includes a recent Practice Statement on materiality judgements that you will not have met before, so work through this part carefully. **Stop and think** Is it possible for a financial report to	IAS 1 formats will be 'taken as read' in your exam. One issue that could come up is that of other comprehensive income, and whether an item may be reclassified from other comprehensive income to profit or loss.	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
		provide too much information?		
2	**IFRS 8, *Operating Segments*** External users of financial statements rely on the limited disaggregation provided as a result of the requirements of accounting standards such as the disclosure of segmental information.	**Approach** This topic is new at Advanced Level, so needs to be worked through carefully. The best way to learn is by looking at the summary in 3.6.1 and the example and proforma in 3.6.3 and 3.6.4. **Stop and think** How does disaggregation of data help facilitate the assessment of a company's performance?	As IFRS 8 is a disclosure standard, it is likely to come up in the context of financial analysis and also audit.	**IQ1: Segments** This question tests reportable segments requiring application of size criteria and aggregation.
3	**IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*** External users of financial statements rely on the limited disaggregation provided as a result of the requirements of accounting standards such as the disclosure of discontinued operations.	**Approach** You have studied this topic at Professional Level, so work through quickly then do the interactive question. **Stop and think** How do standards such as IFRS 5 and IFRS 8 help provide disaggregated information to users?	Both assets held for sale and discontinued operations are regularly tested, both in the single silo FR question and the integrated question. Scenarios are often very detailed and IFRS 5 will interact with other standards, such as IAS 10.	**IQ2: Held for sale** This question asks you to apply the held-for-sale criteria. Make sure you come to a conclusion.
4	**IAS 24, *Related Party Disclosures*** Related party transactions happen in any size of entity, and are perfectly legal, but need to be disclosed.	**Approach** You have met this standard in your earlier studies but as it comes up quite regularly, it is best to approach it as if learning it from scratch.	As a disclosure standard, IAS 24 is often tested in the context of audit. It can also come up in the context of group accounts.	**IQ4: Related party transactions** This question tests related parties in a group context.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
		Stop and think What is the significance in terms of the company's performance of disclosing related party transactions?		
5	**IFRS 1, *First-time Adoption of International Financial Reporting Standards*** While this standard is within the syllabus, and has affected companies in practice, it is not as significant for your exam.	**Approach** This standard is examinable at Level C and has not yet been examined, so read through but not at the expense of other standards in this chapter. **Stop and think** Questions will generally feature companies that already use IFRS rather than adopting it for the first time.	As yet undetermined as this standard has not been examined.	**IQ5: IFRS 1** Read through the question and 'audit' the answer.
6	**IAS 34, *Interim Financial Reporting*** The preparation of interim financial statements may present a number of challenges. It is common for some business arrangements, such as supply pricing agreements, bonus schemes, taxation and overhead allocation, to be based on annualised approaches. The measurement and presentation of such information may therefore be complex.	**Approach** IAS 34, *Interim Financial Reporting* (a new topic at Advanced Level) lays down the principles and guidelines for the production of interim reports. **Stop and think** What does IAS 34 say about holiday pay?	The key point to remember if IAS 34 comes up in an exam is that an entity should use the same recognition and measurement principles in its interim statements as it does in its annual financial statements.	**IQ6: Interim financial statements** This short question deals with the appropriate tax rate to apply to the profits in an interim report.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
7	**IFRS 14, *Regulatory Deferral Accounts*** This is a fairly minor standard for the purposes of your studies	**Approach** IFRS 14, *Regulatory Deferral Accounts* is in the syllabus, but is not a key topic and has not yet been examined. **Stop and think** IFRS 14 tackles an accounting mismatch. Can you think of another IFRS that does this?	This standard has not yet been examined and is given Level C in the syllabus. However, it could still be examined, though not in as much detail as some of the other IFRS.	N/A
8	**Audit focus – general issues with reporting performance** This is a brief section outlining general issues with performance in the context of ISA 200	**Approach** Read through quickly **Stop and think** Is the auditor concerned only with fraud?	An exam will test specifics rather than general points.	N/A
9	**Audit focus – specific issues** This section gives detailed guidance on the audit of: • Segment information • Held-for-sale assets • Related parties • First-time adoption of IFRS	**Approach** Work through all of this section, focusing particularly on the audit of related parties as this comes up a lot. **Stop and think** How would the auditor determine whether the IFRS 5 held for sale criteria have been met?	Many questions have a scenario in which you are asked to explain the financial reporting treatment and then discuss audit issues. It makes sense to do the FR first as the audit follows on from that. However, questions may also be set in which the financial reporting arises from the audit issue. This approach is a key difference from Professional Level.	**IQ7: Audit procedures – held-for-sale assets** This question is in the style of (though shorter) one you might get as part of Question 3.

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 IAS 1, *Presentation of Financial Statements*

Section overview

- IAS 1, *Presentation of Financial Statements* sets down the format of financial statements, containing requirements as to their presentation, structure and content.

1.1 Main features

1.1.1 Titles of financial statements

- The three main financial statements under IAS 1 are as follows:
- Statement of financial position
- Statement of profit or loss and other comprehensive income
- Statement of cash flows

You may still see the older names, particularly balance sheet for statement of financial position as these titles are not mandatory.

1.1.2 Reporting owner changes in equity and comprehensive income

IAS 1 classifies changes in equity in a period as either:

- **owner changes** in equity; or
- **non-owner changes** in equity.

Owner changes in equity arise from transactions with owners in their capacity as owners, eg, dividends paid and issues of share capital. These are presented in the statement of changes in equity.

Non-owner changes in equity (known as 'comprehensive income') include:

- the profit or loss for the period; and
- income or expenditure recognised directly in equity (known as 'other comprehensive income').

These are presented in the statement of profit or loss and other comprehensive income.

Summary

	IAS 1
Profit or loss for period	Statement of profit or loss and other comprehensive income
Non-owner transactions recognised directly in equity	
Owner transactions	Statement of changes in equity

1.1.3 Presentation of comparatives

IAS 1 requires disclosure of comparative information in respect of the previous period. It also requires inclusion of a statement of financial position as at the beginning of the earliest comparative period when an entity:

- retrospectively applies an accounting policy;
- retrospectively restates items in the financial statements; or
- reclassifies items in the financial statements.

In effect this will result in the presentation of three statements of financial position when there is a prior period adjustment.

1.2 Materiality and aggregation

Entities must be able to use judgement when presenting their financial reports. Accordingly, the following are required by IAS 1 paragraph 30A:

(a) Materiality. Information should not be obscured by aggregating or by providing immaterial information. Materiality considerations apply to the parts of the financial statements. Materiality considerations still apply, even when a standard requires a specific disclosure.

(b) Statement of financial position and statement of profit or loss and other comprehensive income. The list of line items to be presented in these statements can be disaggregated and aggregated as relevant and additional guidance is given on subtotals in these statements. An entity's share of other comprehensive income of equity-accounted associates and joint ventures should be presented in aggregate as single line items based on whether or not it will subsequently be reclassified to profit or loss.

Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general-purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report. (IAS 1: para. 7)

The IASB has amended the definition of 'material' to make it clear that obscuring information has the same effect as omitting or misstating it. Obscuring information means making the information so difficult to find or so difficult to understand, that it may as well have been omitted.

This addresses the issue that too much information can be just as problematic as the omission or misstatement of information.

1.2.1 Practice Statement 2: Making Materiality Judgements

The IASB issued Practice Statement 2: *Making Materiality Judgements* in 2017. This is a tool to aid management in using judgement to decide what information is material and what is not; it is a non- mandatory document and does not have the status of an IFRS® Standard.

The key point is a four-step process for making materiality judgements:

Step 1 Identify information that has the potential to be material. This step requires consideration of IFRS requirements and the common information needs of primary users.

Step 2 Assess whether the information identified is material. Both quantitative and qualitative factors should be considered.

Step 3 Organise the information within the draft financial statements so that it supports clear and concise communication.

Step 4 Review the information provided as a whole, considering whether it is material individually and in combination with other information. At this stage information may need to be added or removed.

Professional skills focus: Assimilating and using information

This Practice Statement is an example of where two professional skills interact. In order to apply judgement, you need to identify the relevant information, taking into account IFRS requirements and users' information needs.

Professional skills focus: Applying judgement

Having assimilated and organised the information (steps 1 to 3 of the Practice Statement process), you will be in a position to make judgements about whether it is material. Other information may be needed to support the judgements.

1.3 Statement of financial position

Note that reserves other than share capital and retained earnings may be grouped as 'other components of equity'.

Statement of financial position as at 31 December 20X7

	31 Dec 20X7 $m	31 Dec 20X6 $m
ASSETS		
Non-current assets		
Property, plant and equipment	X	X
Goodwill	X	X
Other intangible assets	X	X
Investments in associates	X	X
Investments in equity instruments	X	X
	X	X
Current assets		
Inventories	X	X
Trade receivables	X	X
Other current assets	X	X
Cash and cash equivalents	X	X
	X	X
Total assets	X	X
EQUITY AND LIABILITIES		
Equity attributable to owners of the parent		
Share capital	X	X
Retained earnings	X	X
Other components of equity	X	X
	X	X
Non-controlling interests	X	X
Total equity	X	X
Non-current liabilities		
Long-term borrowings	X	X
Deferred tax	X	X
Long-term provisions	X	X
Total non-current liabilities	X	X
Current liabilities		
Trade and other payables	X	X
Short-term borrowings	X	X
Current portion of long-term borrowings	X	X
Current tax payable	X	X

	31 Dec 20X7	31 Dec 20X6
	$m	**$m**
Short-term provisions	X	X
Total current liabilities	X	X
Total liabilities	X	X
Total equity and liabilities	X	X

1.4 Statement of profit or loss and other comprehensive income

The statement of profit or loss and other comprehensive income presents the total comprehensive income of an entity for a period.

Total comprehensive income is the change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners. It includes all components of profit or loss and of 'other comprehensive income'.

Other comprehensive income includes income and expenses that are not recognised in profit or loss, but instead recognised directly in equity. It includes:

- changes in the revaluation surplus;
- remeasurements (actuarial gains and losses) on defined benefit plans recognised in accordance with IAS 19, *Employee Benefits* (Chapter 18);
- gains and losses arising from translating the financial statements of a foreign operation (Chapter 21);
- gains and losses on remeasuring investments in equity instruments where an irrevocable election has been made to record changes in OCI (Chapter 16); and
- the effective portion of gains and losses on hedging instruments in a cash flow hedge (Chapter 17).

1.4.1 Presentation of other comprehensive income

The **blurring of distinctions** between different items in OCI is the result of an underlying **general lack of agreement** among users and preparers about **which items should be presented in OCI** and which should be part of the profit or loss section. For instance, a common misunderstanding is that the split between profit or loss and OCI is on the basis of realised versus unrealised gains. This is not, and has never been, the case.

This lack of a consistent basis for determining how items should be presented can lead to the somewhat inconsistent use of OCI in financial statements.

Professional skills focus: Applying judgement

This is an example where judgement can shade into subjectivity, and more specific guidance is needed to focus the judgement of the preparer of financial statements.

IAS 1 approach

Entities are required to group items presented in OCI on the basis of **whether they would be reclassified** to (recycled through) profit or loss at a later date, when specified conditions are met.

The amendment does not address which items are presented in OCI or which items need to be reclassified.

Income tax

IAS 1 requires an entity to disclose income tax relating to each component of OCI. This is because these items often have tax rates different from those applied to profit or loss. This may be achieved by either:

- presenting individual components of OCI net of the related tax; or
- presenting individual components of OCI before tax, with one amount shown for the aggregate amount of income tax relating to those components.

Presentation

IAS 1 allows comprehensive income to be presented in two ways:

(a) A single statement of profit or loss and other comprehensive income; or

(b) A statement displaying components of profit or loss plus a second statement beginning with profit or loss and displaying components of OCI (statement of profit or loss and other comprehensive income).

The recommended format of a single statement of profit or loss and other comprehensive income is as follows:

Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7

	20X7	20X6
	$m	$m
Revenue	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the year from continuing operations	X	X
Loss for the year from discontinued operations		(X)
PROFIT FOR THE YEAR	X	X
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	X	X
Investment in equity instruments	(X)	X
Actuarial gains (losses) on defined benefit pension plans	(X)	X
Share of gain (loss) on property revaluation of associates	X	(X)
Income tax relating to items that will not be reclassified	X	(X)
	(X)	X
Items that may be reclassified subsequently to profit or loss:		
Exchange differences on translating foreign operations	X	X
Cash flow hedges	(X)	(X)

	20X7 $m	20X6 $m
Income tax relating to items that may be reclassified	(X)	(X)
	X	X
Other comprehensive income for the year, net of tax	(X)	X
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	X	X
Profit attributable to:		
Owners of the parent	X	X
Non-controlling interests	X	X
	X	X
Total comprehensive income attributable to:		
Owners of the parent	X	X
Non-controlling interests	X	X
	X	X
Earnings per share ($)		
Basic and diluted	X	X

Alternatively, components of OCI could be presented in the statement of profit or loss and other comprehensive income net of tax.

Statements of profit or loss

Throughout this Workbook, income and expense items which are included in the 'top half' of the statement of profit or loss and other comprehensive income are referred to as recognised in profit or loss, or recognised in the income statement.

Income and expense items included in the 'bottom half' of the statement of profit or loss and other comprehensive income are referred to as recognised in other comprehensive income.

For exam purposes, you must ensure that you clarify where in the statement of profit or loss and other comprehensive income an item is recorded, by referring to recognition:

- in profit or loss; or
- in other comprehensive income.

1.5 Statement of changes in equity

All changes in equity arising from transactions with owners in their capacity as owners are shown in the statement of changes in equity.

Non-owner transactions are not permitted to be shown in the statement of changes in equity other than in aggregate.

Statement of changes in equity for the year ended 31 December 20X7

	Share capital	Retained earnings	Trans. of foreign ops	Inv. in equity instrum en	Cash flow	Revaluat ion surplus	Total	Non-controlling interest	Total equity
	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000
Balance at 1 Jan 20X7	X	X	(X)	X	X	–	X	X	X
Changes in acc'g policy	–	X	–	–	–	–	X	–	X
Restated balance	X	X	(X)	X	X	–	X	X	X
Changes in equity during 20X7									
Issueof share capital	X	–	–	–	–	–	X	–	X
Dividends	–	(X)	–	–	–	–	(X)	(X)	(X)
Total comp. income for the year	–	X	X	X	X	X	X	X	X
Transfer to retained earn'gs	–	X	–	–	–	(X)	–	–	–
Balance at 31 Dec 20X7	X	X	X	X	X	X	X	X	X

A comparative statement for the prior period is alsorequired. Here is an example of a statement of changes in equity with somereal figures in, to give you a better idea of what it looks like:

Olive Group: statement of changes in equity for the year ended 30 June 20X9

Share Balance	Share capital	Retained earnings	Inv. in equity instrum'ts	Revaluat'n surplus	Total	Non-controlling interest	Total equity
	£m	£m	£m	£m	£m	£m	£m
Balanceat 1 July 20X8	14,280	10,896	384	96	25,656	1,272	26,928
Share capital issued	1,320				1,320		1,320
Dividends		(216)			(216)	(120)	(336)
Total comp. incomefor the year		(1,296)	72	48	(1,176)	528	(648)
Balance at 30 June 20X9	15,600	9,384	456	144	25,584	1,680	27,264

2 IFRS 8, *Operating Segments*

Section overview

An important aspect of reporting financial performance is **segment reporting**. This is covered by IFRS 8, *Operating Segments*.

IFRS 8 is a **disclosure standard**.

- **Segment reporting** is necessary for a better understanding and assessment of:
  - past performance;
  - risks and returns; and
  - informed judgements.
- IFRS 8 adopts the **managerial approach** to identifying segments.
- The standard gives guidance on how segments should be **identified** and **what information should be disclosed** for each.

It also sets out **requirements for related disclosures** about products and services, geographical areas and major customers.

1.1 Introduction

Large entities produce a wide range of products and services, often in several different countries. Further information on how the overall results of entities are made up from each of these product or geographical areas will help the users of the financial statements. This is the reason for **segment reporting**.

- The entity's **past performance** will be better understood.
- The entity's **risks and returns** may be better assessed.
- More **informed judgements** may be made about the entity as a whole.

Risks and returns of a **diversified, multinational company** can be better assessed by looking at the individual risks and rewards attached to groups of products or services or in different geographical areas. These are subject to differing rates of profitability, opportunities for growth, future prospects and risks.

1.2 Objective and scope

An entity must disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

Only entities whose **equity or debt securities are publicly traded** (ie, on a stock exchange) need disclose segment information. In group accounts, only **consolidated** segmental information needs to be shown. (The statement also applies to entities filing or in the process of filing financial statements for the purpose of issuing instruments.)

1.3 Definition of operating segment

Definition

Operating segment: This is a component of an entity:

- that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity);

- whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance; and
- for which discrete financial information is available.

The term 'chief operating decision maker' identifies a function, not necessarily a manager with a specific title. That function is to allocate resources and to assess the performance of the entity's operating segments.

1.4 Aggregation

Two or more operating segments may be **aggregated** if the segments have **similar economic characteristics**, and the segments are similar in all of the following respects:

- The nature of the products or services
- The nature of the production process
- The type or class of customer for their products or services
- The methods used to distribute their products or provide their services
- If applicable, the nature of the regulatory environment

1.5 Determining reportable segments

An operating segment is reportable where:

- It meets the definition of an operating segment; and
- Any of the following size criteria are met:
  - Segment **revenue** ≥ 10% of total (internal and external) revenue
  - Segment **profit or loss** ≥ 10% of the profit of all segments in profit (or loss of all segments making a loss if greater)
  - Segment **assets** ≥ 10% of total assets

At least **75% of total external revenue** must be reported by operating segments. Where this is not the case, additional segments must be identified (even if they do not meet the 10% thresholds).

2.5.1 Aggregating segments

Two or more operating segments **below** the thresholds may be aggregated to produce a reportable segment if the segments have similar economic characteristics, and the segments are similar in a **majority** of the aggregation criteria above.

Evidence of similar economic characteristics is given by **similar long-term financial performance**. For example, similar long-term average gross margins for two operating segments would be expected if their economic characteristics were similar.

2.5.2 Non-reportable segments

Operating segments that do not meet **any of the quantitative thresholds** may be reported separately if management believes that information about the segment would be useful to users of the financial statements.

Non-reportable segments are required by IFRS 8 to be combined and disclosed in an 'all other segments' category separate from other reconciling items in the reconciliations required by IFRS8. Entities must disclose the sources of revenue in the 'all other segments' category.

Professional skills focus: Structuring problems and solutions

IFRS 8 provides a framework for structuring the problem of comparing like with like and identifying important areas of the business. First segments need to be identified – not always easy in real life or in the exam. Then the relevant disclosures need to be made.

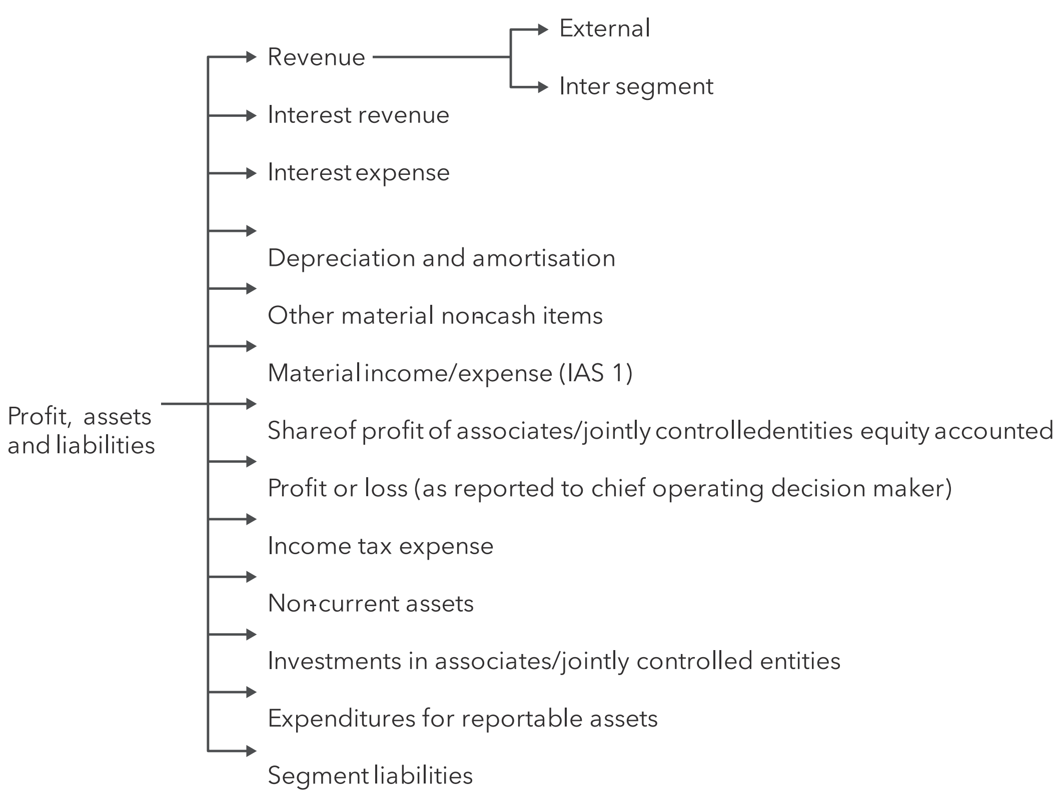
1.6 Disclosures

1.6.1 Segment disclosures

Disclosures required by the IFRS are extensive and best learned by looking at the example and pro forma, which follow the list. Disclosure is required of:

- Factors used to identify the entity's reportable segments
- **Types of products and services** from which each reportable segment derives its revenues
- For each reportable segment:
  - Operating segment profit or loss
  - Segment assets
  - Segment liabilities
  - Certain income and expense items

Figure 9.1: IFRS 8 Disclosures



A **reconciliation** of each of the above material items to the entity's reported figures is required.

Reporting of a measure of **profit or loss** by segment is compulsory. Other items are disclosed if included in the figures reviewed by or regularly provided to the chief operating decision maker.

1.6.2 Entity-wide disclosures

The following disclosures are required for the whole entity:

- **External revenue** by each product and service (if reported basis is not products and services)
- **Geographical information**:

Geographical areas → External revenue / Non-current assets by:
- entity's country of domicile, and
- all foreign countries (subdivided if material)

Notes

1 External revenue is allocated based on the customer's location.

2 Non-current assets exclude financial instruments, deferred tax assets, post-employment benefit assets, and rights under insurance contracts.

- Information about **reliance on major customers** (ie, those who represent more than 10% of external revenue)

1.6.3 Disclosure example from IFRS 8

The following example is adapted from the IFRS 8 *Implementation Guidance*, which emphasises that this is for illustrative purposes only and that the information must be presented in the most understandable manner in the specific circumstances.

The hypothetical company does not allocate tax expense (tax income) or non-recurring gains and losses to reportable segments. In addition, not all reportable segments have material noncash items other than depreciation and amortisation in profit or loss. The amounts in this illustration, denominated as dollars, are assumed to be the amounts in reports used by the chief operating decision maker.

	Car parts	**Motor vessel**	**Software**	**Electronics**	**Finance**	**All other**	**Totals**
	$	**$**	**$**	**$**	**$**	**$**	**$**
Revenues from external customers	3,000	5,000	9,500	12,000	5,000	1,000	35,500
Inter-segment revenues	–	–	3,000	1,500	–	–	4,500
Interest revenue	450	800	1,000	1,500	–	–	3,750
Interest expense	350	600	700	1,100	–	–	2,750
Net interest revenue	–	–	–	–	1,000	–	1,000
Depreciation and amortisation	200	100	50	1,500	1,100	–	2,950
Reportable segment profit	200	70	900	2,300	500	100	4,070
Other material non-cash items:							
Impairment of assets	–	200	–	–	–	–	200
Reportable segment assets	2,000	5,000	3,000	12,000	57,000	2,000	81,000
Expenditure for reportable segment non-current assets	300	700	500	800	600	–	2,900
Reportable segment liabilities	1,050	3,000	1,800	8,000	30,000	–	43,850

- 'All other' segment results are attributable to four operating segments of the company which do not meet the quantitative thresholds. Those segments include a small property business, an electronics equipment rental business, a software consulting practice and a warehouse leasing operation. None of those segments has ever met any of the quantitative thresholds for determining reportable segments.
- The finance segment derives a majority of its revenue from interest. Management primarily relies on net interest revenue, not the gross revenue and expense amounts, in managing that segment. Therefore, as permitted by IFRS 8, only the net amount is disclosed.

1.6.4 Suggested pro forma

Information about profit or loss, assets and liabilities

	Segment A	Segment B	Segment C	All other segments	Inter segment	Entity total
Revenue – external customers	X	X	X	X	–	X
Revenue – inter segment	X	X	X	X	(X)	–
	X	X	X	X	(X)	X
Interest revenue	X	X	X	X	(X)	X
Interest expense	(X)	(X)	(X)	(X)	X	(X)
Depreciation and amortisation	(X)	(X)	(X)	(X)	–	(X)
Other material non-cash items	X/(X)	X/(X)	X/(X)	X/(X)	X/(X)	X/(X)
Material income/expense (IAS 1)	X/(X)	X/(X)	X/(X)	X/(X)	X/(X)	X/(X)
Share of profit of associate/JVs	X	X	X	X	–	X
Segment profit before tax	X	X	X	X	(X)	X
Income tax expense	(X)	(X)	(X)	(X)	–	(X)
Unallocated items						X/(X)
Profit for the period						X
Segment assets	X	X	X	X	(X)	X
Investments in associate/JVs	X	X	X	X	–	X
Unallocated assets						X
Entity's assets						X
Expenditures for reportable assets	X	X	X	X	(X)	X
Segment liabilities	X	X	X	X	(X)	X
Unallocated liabilities						X
Entity's liabilities						X

Information about geographical areas	Country of domicile	Foreign countries	Total
Revenue – external customers	X	X	X
Non-current assets	X	X	X

Interactive question 1: Segments

Endeavour, a public limited company, trades in six business areas which are reported separately in its internal accounts provided to the chief operating decision maker. The results of these segments for the year ended 31 December 20X5 are as follows.

Operating segment information as at 31 December 20X5

	External revenue £m	Internal revenue £m	Total revenue £m	Segment profit/ (loss) £m	Segment assets £m	Segment liabilities £m
Chemicals:						
Europe	14	7	21	1	31	14
Rest of world	56	3	59	13	78	34
Pharmaceuticals wholesale	59	8	67	9	104	35
Pharmaceuticals retail	22	0	22	(2)	30	12
Cosmetics	12	3	15	2	18	10
Hair care	11	1	12	4	21	8
Body care	18	24	42	(6)	54	19
	192	46	238	21	336	132

Requirement

Which of the operating segments of Endeavour constitute a 'reportable' operating segment under IFRS 8, *Operating Segments* for the year ending 31 December 20X5?

See **Answer** at the end of this chapter.

3 IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*

Section overview

IFRS 5 requires assets and groups of assets that are 'held for sale' to be **presented separately** on the face of the statement of financial position and the results of discontinued operations to be presented separately in the statement of profit or loss and other comprehensive income. This is required so that users of financial statements will be better able to make **projections** about the financial position, profits and cash flows of the entity based on continuing operations only.

Definition

Disposal group: A group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction. (In practice a disposal group could be a subsidiary, a cash-generating unit or a single operation within an entity.)

(IFRS 5)

A disposal group could form a group of cash-generating units, a single cash-generating unit or be part of a cash-generating unit.

The disposal group should include goodwill if it is a cash-generating unit (or group of cash-generating units to which goodwill has been allocated under IAS 36). Only goodwill recognised in the statement of financial position can be included in the disposal group. If a previous generally accepted accounting practice (GAAP) allowed goodwill to be recorded directly in reserves, this goodwill does not form part of a disposal group.

A disposal group may include current and non-current assets and current and non-current liabilities. However, only liabilities that will be transferred as part of the transaction are classified as part of the disposal group. If any liabilities remain with the vendor, these are not included in the scope of IFRS 5.

IFRS 5 does not apply to certain assets covered by other accounting standards:

- Deferred tax assets (IAS 12)
- Assets arising from employee benefits (IAS 19)
- Financial assets (IFRS 9)
- Investment properties accounted for in accordance with the fair value model (IAS 40)
- Agricultural and biological assets that are measured at fair value less estimated point of sale costs (IAS 41)
- Insurance contracts (IFRS 4)

3.1 Classification of assets held for sale

A non-current asset (or disposal group) should be classified as **held for sale** if its carrying amount will be recovered **principally through a sale transaction** rather than **through continuing use**. A number of detailed criteria must be met:

- The asset must be **available for immediate sale** in its present condition.
- Its sale must be **highly probable** (ie, significantly more likely than not).

For the sale to be highly probable, the following must apply.

- Management must be **committed** to a plan to sell the asset.
- There must be an active programme to **locate a buyer**.
- The asset must be marketed for sale at a **price that is reasonable** in relation to its current fair value.
- The sale should be expected to take place **within one year** from the date of classification.
- It is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

An asset (or disposal group) can still be classified as held for sale, even if the sale has not actually taken place within one year. However, the delay must have been **caused by events or circumstances beyond the entity's control** and there must be sufficient evidence that the entity is still committed to sell the asset or disposal group. Otherwise the entity must cease to classify the asset as held for sale.

Subsidiaries acquired exclusively with a view to resale

If an entity acquires a disposal group (eg, a subsidiary) exclusively with a view to its subsequent disposal it can classify the asset as held for sale only if the sale is expected to take place within one year and it is highly probable that all the other criteria will be met within a short time (normally three months).

Abandoned assets

An asset that is to be **abandoned** should not be classified as held for sale. This is because its carrying amount will be recovered principally through continuing use. However, a disposal group that is to be abandoned may meet the definition of a discontinued operation and therefore separate disclosure may be required (see below).

Interactive question 2: Held for sale

On 1 December 20X3, a company became committed to a plan to sell a manufacturing facility and has already found a potential buyer. The company does not intend to discontinue the operations currently carried out in the facility. At 31 December 20X3 there is a backlog of uncompleted customer orders. The subsidiary will not be able to transfer the facility to the buyer until after it ceases to operate the facility and has eliminated the backlog of uncompleted customer orders. This is not expected to occur until Spring 20X4.

Requirement

How should the manufacturing facility be accounted for as at 31 December 20X3?

See **Answer** at the end of this chapter.

3.2 Measurement of assets held for sale

A non-current asset (or disposal group) that is held for sale should be measured at the **lower of** its **carrying amount** and **fair value less costs to sell** (net realisable value).

An impairment loss should be recognised where fair value less costs to sell is lower than carrying amount. Note that this is an exception to the normal rule. IAS 36, *Impairment of Assets* requires an entity to recognise an impairment loss only where an asset's recoverable amount is lower than its carrying value. Recoverable amount is defined as the higher of **net realisable value** and **value in use**. IAS 36 does not apply to assets held for sale.

Non-current assets held for sale **should not be depreciated**, even if they are still being used by the entity.

A non-current asset (or disposal group) that is **no longer classified as held for sale** (for example, because the sale has not taken place within one year) is measured at the **lower of the following**:

- Its **carrying amount** before it was classified as held for sale, adjusted for any depreciation that would have been charged had the asset not been held for sale
- Its **recoverable amount** at the date of the decision not to sell

3.3 Presenting discontinued operations

Definition

Discontinued operation: A component of an entity that has either been disposed of, or is classified as held for sale, and:

- represents a separate major line of business or geographical area of operations;
- is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations; or
- is a subsidiary acquired exclusively with a view to resale.

Operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.

An entity should **present and disclose information** that enables users of the financial statements to evaluate the financial effects of **discontinued operations** and disposals of non-current assets or disposal groups.

An entity should disclose a **single amount** on the **face of the statement of profit or loss and**

other comprehensive income (or statement of profit or loss where presented separately) comprising the total of:

- the **post-tax profit or loss** of discontinued operations; and
- the post-tax gain or loss recognised on the **measurement to fair value less costs to sell** or on the disposal of the assets or disposal group(s) constituting the discontinued operation.

An entity should also disclose an **analysis** of the above single amount into:

- the revenue, expenses and pre-tax profit or loss of discontinued operations;
- the related income tax expense;
- the gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or the discontinued operation; and
- the related income tax expense.

This may be presented either on the face of the statement of profit or loss and other comprehensive income or in the notes. If it is presented on the face of the statement of profit or loss and other comprehensive income it should be presented in a section identified as relating to discontinued operations, ie, separately from continuing operations. This analysis is not required where the discontinued operation is a newly acquired subsidiary that has been classified as held for sale.

An entity should disclose the **net cash flows** attributable to the operating, investing and financing activities of discontinued operations. These disclosures may be presented either on the face of the statement of cash flows or in the notes.

Gains and losses on the remeasurement of a disposal group that is not a discontinued operation but is held for sale should be included in profit or loss from continuing operations.

Interactive question 3: Closure

On 20 October 20X3 the directors of a parent company made a public announcement of plans to close a steel works. The closure means that the group will no longer carry out this type of operation, which until recently has represented about 10% of its total revenue. The works will be gradually shut down over a period of several months, with complete closure expected in July 20X4. At 31 December 20X3 output had been significantly reduced and some redundancies had already taken place. The cash flows, revenues and expenses relating to the steel works can be clearly distinguished from those of the subsidiary's other operations.

Requirement

How should the closure be treated in the financial statements for the year ended 31 December 20X3?

See **Answer** at the end of this chapter.

3.4 Presentation of a non-current asset or disposal group classified as held for sale

Non-current assets and disposal groups classified as held for sale should be **presented separately** from other assets in the statement of financial position. The liabilities of a disposal group should be presented separately from other liabilities in the statement of financial position.

- Assets and liabilities held for sale **should not be offset**.
- The **major classes** of assets and liabilities held for sale should be **separately disclosed** either on the face of the statement of financial position or in the notes.

3.5 IFRS 5 and impairment

There are particular rules on impairment in the context of IFRS 5. These are covered in Chapter 12, section 1.4 of this Workbook.

3.6 Additional disclosures

In the period in which a non-current asset (or disposal group) has been either classified as held for sale or sold, the following should be disclosed.

(a) A **description** of the non-current asset (or disposal group)

(b) A description of the **facts and circumstances** of the disposal

(c) Any **gain or loss** recognised when the item was classified as held for sale

(d) If applicable, the **segment** in which the non-current asset (or disposal group) is presented in accordance with IFRS 8, *Operating Segments*

Where an asset previously classified as held for sale is **no longer held for sale**, the entity should disclose a description of the facts and circumstances leading to the decision and its effect on results.

4 IAS 24, Related Party Disclosures

Section overview

The objective of IAS 24 is to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and/or profit or loss may have been affected by the existence of related parties or by related party transactions.

4.1 Overview of material from earlier studies

Scope

IAS 24 requires disclosure of related party transactions, and outstanding balances, in the separate financial statements of:

- a parent;
- a venturer; or
- an investor.

What constitutes a related party?

A related party is a person or entity that is related to the entity that is preparing its financial statements.

(a) A **person** or a close member of that person's family is **related** to a reporting entity if that person:

  (1) has control or joint control over the reporting entity;

  (2) has significant influence over the reporting entity; or

  (3) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.

(b) An **entity** is related to a reporting entity if any of the following conditions apply:

  (1) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).

(2) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).

(3) Both entities are joint ventures of the same third party.

(4) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.

(5) The entity is a post-employment defined benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.

(6) The entity is controlled or jointly controlled by a person identified in (a).

(7) A person identified in (a)(1) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).

(8) The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or the parent of the reporting entity.

Exclusions

- **Two entities simply because they have a director or other key management in common** (notwithstanding the definition of related party above, although it is necessary to consider how that director would affect both entities)
- **Two venturers, simply because they share joint control over a joint venture**
- Certain other bodies, simply as a result of their **role in normal business dealings** with the entity:
  - Providers of finance
  - Trade unions
  - Public utilities
  - Government departments and agencies
- **Any single customer, supplier, franchisor, distributor or general agent** with whom the entity transacts a significant amount of business, simply by virtue of the resulting economic dependence

What constitutes a related party transaction?

Definition

Related party transaction: A transfer of resources, services or obligations between related parties, regardless of whether a price is charged.

What must be disclosed?

- **A related party relationship between parent and subsidiaries**
- **Compensation**, being the consideration in exchange for their services, received by key management personnel
- **Disclosures** required about related parties **only if transactions have taken place between them during the period**:
  - The nature of the relationship (but remember this must always be disclosed in respect of a parent)
  - The amount of the transactions
  - The amount of any balance outstanding at the year end
  - The terms and conditions attaching to any outstanding balance (for example, whether

  security or guarantees have been provided and what form the payment will take)
  - If an amount has been provided against or written off any outstanding balance due
- **Disclosure** of the fact that transactions are on an **arm's length basis** (the term 'arm's length' continues to be used in the context of IAS 24, even though it has been removed from the definition of fair value in IFRS 13 (see Chapter 2, section 4))

Interactive question 4: Related party transactions

P owns S and a number of other subsidiaries. The following details relate to amounts due to the key management personnel (KMP) of P and of S for the year ended 31 December 20X5.

	£
Salaries and related taxes payable by S to its KMP for services rendered to S	500,000
Salaries and related taxes payable by P to S's KMP for services rendered to S	60,000
Salaries and related taxes payable by S to its KMP for services rendered to P	20,000
Pension benefits accruing within the group-wide pension scheme to S's KMP for services rendered to S	50,000
Share options granted under the group-wide share option scheme to S's KMP for services rendered to S 28,000	
	658,000

Requirement

What transactions should be disclosed as key management personnel compensation in the financial statements of S?

See **Answer** at the end of this chapter.

4.2 Application of substance over form

Under IAS 24 attention should be directed to the **substance** of the relationship rather than focusing on its legal form. For example, the following **are not related parties**:

- Two entities **simply because they have a director** (or other member of key management personnel) **in common**, or because a member of key management personnel of one entity has significant influence over the other entity
- Two venturers **simply because they share joint control over a joint venture**
- Providers of finance, trade unions, public utilities and government departments and agencies of a government that does not control, jointly control or significantly influence the reporting entity **simply by virtue of their normal dealings with an entity**
- A customer, supplier, franchisor, distributor or general agent, with whom an entity transacts a significant volume of business, **simply by virtue of the resulting economic dependence**

Context example: Related parties

The following examples illustrate the application of the definition of a related party to practical situations:

(a) Alan Jones owns 30% of Benson Co and Clark Co owns 40% of Benson Co. The remaining 30% is held by many unconnected shareholders.

Benson Co is the reporting entity:

Alan Jones is a related party under definition (a)(2) and Clark Co is a related party under definition (b)(2)

Clark Co is the reporting entity:

Benson Co is a related party under definition (b)(2)

(b) Alan Jones and Benson Co have joint control over Clark Co Benson Co is the reporting entity:
Clark Co is a related party under definition (b)(2) Clark Co is the reporting entity:
Alan Jones is a related party under definition (a)(1) and Benson Co is a related party under definition (b)(2)

(c) Alan Jones is a non-executive director of Benson Co Benson Co is the reporting entity:
Alan Jones falls within the definition of Benson Co's key management personnel and is a related party under definition (a)(3)

(d) Alan Jones owns 70% of Benson Co and is a director of Clark Co Benson Co is the reporting entity:
Alan Jones is a related party under definition (a)(1) and Clark Co is a related party under definition (b)(7)

Clark Co is the reporting entity:

Alan Jones falls within the definition of Clark Co's key management personnel and is a related party under definition (b)(3)

Benson Co is a related party under definition (b)(6)

5 IFRS 1, *First-time Adoption of International Financial Reporting Standards*

Section overview

- IFRS 1 gives guidance to entities applying IFRS Standards for the first time.

The adoption of a new body of accounting standards will inevitably have a significant effect on the accounting treatments used by an entity and on the related **systems and procedures**. In 2005 many countries adopted IFRS for the first time and over the next few years other countries are likely to do the same.

In addition, many Alternative Investment Market (AIM) companies and public sector companies adopted IFRS Standards for the first time for accounting periods ending in 2009 and 2010. US companies are likely to move increasingly to IFRS, although the US Securities and Exchange Commission did not give any definite timeline for this in its 2012 work plan.

IFRS 1, *First-time Adoption of International Financial Reporting Standards* was issued to ensure that an entity's first IFRS financial statements contain high quality information that fulfil the following criteria:

- It is transparent for users and comparable over all periods presented.
- It provides a suitable starting point for accounting under IFRS Standards.
- It can be generated at a cost that does not exceed the benefits to users.

5.1 General principles

An entity applies IFRS 1 in its first IFRS financial statements.

An entity's first IFRS financial statements are the first annual financial statements in which the entity adopts IFRS Standards by an **explicit and unreserved statement of compliance** with IFRS Standards.

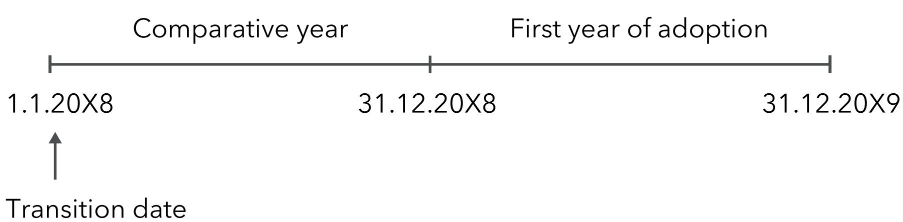
Any other financial statements (including fully compliant financial statements that did not state so) are not the first set of financial statements under IFRS Standards.

5.2 Opening IFRS statement of financial position

An entity **prepares and presents** an **opening IFRS statement of financial position** at the date of transition to IFRS Standards as a starting point for IFRS accounting.

Generally, this will be the beginning of the **earliest comparative period shown** (ie, full retrospective application). Given that the entity is applying a change in accounting policy on adoption of IFRS 1, IAS 1, *Presentation of Financial Statements* requires the presentation of **at least three statements of financial position** (and two of each of the other statements).

Context example: Opening IFRS SOFP



Preparation of an opening IFRS statement of financial position typically involves adjusting the amounts reported at the same date under previous GAAP.

All adjustments are recognised **directly in retained earnings** (or, if appropriate, another category of equity) not in profit or loss.

5.3 Estimates

Estimates in the opening IFRS statement of financial position must be consistent with estimates **made at the same date under previous GAAP** even if further information is now available (in order to comply with IAS 10).

5.4 Transition process

(a) **Accounting policies**

The entity should select accounting policies that comply with IFRS Standards effective **at the end of the first IFRS reporting period**.

These accounting policies are used in the opening IFRS statement of financial position and throughout all periods presented. The entity does not apply different versions of IFRS Standards effective at earlier dates.

(b) **Derecognition of assets and liabilities**

A previous GAAP statement of financial position may contain items that do not qualify for recognition under IFRS.

Eg, IFRS Standards do not permit capitalisation of research, staff training and relocation costs.

(c) **Recognition of new assets and liabilities**

New assets and liabilities may need to be recognised.

Eg, deferred tax balances and certain provisions such as environmental and decommissioning costs.

(d) **Reclassification of assets and liabilities**

Eg, compound financial instruments need to be split into their liability and equity components.

(e) **Measurement**

Value at which asset or liability is measured may differ under IFRS Standards.

Eg, discounting of deferred tax assets/liabilities not allowed under IFRS Standards.

5.5 Main exemptions from applying IFRS Standards in the opening IFRS statement of financial position

(a) **Property, plant and equipment, investment properties and intangible assets**

- Fair value/previous GAAP revaluation may be used as a substitute for cost at date of transition to IFRS Standards.

(b) **Business combinations**

For business combinations **before** the date of transition to IFRS Standards:

- The same classification (acquisition or uniting of interests) is retained as under previous GAAP.
- For items requiring a cost measure for IFRS Standards, the carrying value **at the date of the business combination** is treated as deemed cost and IFRS rules are applied from thereon.
- Items requiring a fair value measure for IFRS Standards are revalued at the date of transition to IFRS Standards.
- The carrying value of goodwill at the date of transition to IFRS Standards is the amount as reported under previous GAAP.

(c) **Employee benefits**

- Unrecognised actuarial gains and losses can be deemed zero at the date of transition to IFRS Standards. IAS 19 is applied from then on.

(d) **Cumulative translation differences on foreign operations**

- Translation differences (which must be disclosed in a separate translation reserve under IFRS Standards) may be deemed zero at the date of transition to IFRS Standards. IAS 21 is applied from then on.

(e) **Adoption of IFRS Standards by subsidiaries, associates and joint ventures**

If a subsidiary, associate or joint venture adopts IFRS Standards later than its parent, it measures its assets and liabilities **either**:

- at the amount that would be included in the parent's financial statements, based on the parent's date of transition; **or**
- at the amount based on the subsidiary (associate or joint venture)'s date of transition.

Disclosure

- A **reconciliation of previous GAAP equity** to IFRS Standards is required at the date of transition to IFRS Standards and for the most recent financial statements presented under previous GAAP.
- A **reconciliation of profit** for the most recent financial statements presented under previous GAAP.

5.6 Organisational and procedural changes

The technical changes involved in adopting a new body of standards will provide a challenge to company management and their advisers.

These are some of the key issues:

- **Accurate assessment of the task involved.** Underestimation or wishful thinking may hamper the effectiveness of the conversion and may ultimately prove inefficient.
- **Proper planning.** This should take place at the overall project level, but a detailed task analysis could be drawn up to control work performed.
- **Human resource management.** The project must be properly structured and staffed.
- **Training.** Where there are skills gaps, remedial training should be provided.
- **Monitoring and accountability.** A relaxed 'it will be all right on the night' attitude could spell danger. Implementation progress should be monitored and regular meetings set up so that participants can personally account for what they are doing as well as flag up any problems as early as possible. Project drift should be avoided.
- **Achieving milestones.** Successful completion of key steps and tasks should be appropriately acknowledged, ie, what managers call 'celebrating success', so as to sustain motivation and performance.
- **Physical resources.** The need for IT equipment and office space should be properly assessed.
- **Process review.** Care should be taken not to perceive the conversion as a one-off quick fix. Any change in future systems and processes should be assessed and properly implemented.
- **Follow-up procedures.** Good management practice dictates that follow-up procedures should be planned and in place to ensure that the transfer is effectively implemented and that any necessary changes are identified and implemented on a timely basis.
- **Contractual terms**. These may be affected, such as covenants related to borrowing facilities based on statement of financial position ratios. The potential effect of the new standards on these measurements should be assessed and discussed with the lenders at an early stage.

Interactive question 5: IFRS 1

Europa is a listed company incorporated in Molvania. It will adopt International Financial Reporting Standards (IFRS Standards) for the first time in its financial statements for the year ended 31 December 20X8.

The directors of Europa are unclear as to the impact of IFRS 1, *First-time Adoption of International Financial Reporting Standards*.

Advise the directors of Europa on the following.

Requirements

5.1 The procedure for preparing IFRS financial statements for the first time (as required by IFRS 1).

5.2 The practical steps that the company should take in order to ensure an efficient transfer to accounting under IFRS.

5.3 In its previous financial statements for 31 December 20X6 and 20X7, which were prepared under local GAAP, the company:

(1) made a number of routine accounting estimates, including accrued expenses and provisions; and

(2) did not recognise a provision for a court case arising from events that occurred in September 20X7. When the court case was concluded on 30 June 20X8, Europa was required to pay $10 million and paid this on 10 July 20X8, after the 20X7 financial statements were authorised for issue.

In the opinion of the directors, the company's estimates of accrued expenses and provisions under local GAAP were made on a basis consistent with IFRS Standards.

5.4 Discuss how the matters above should be dealt with in the financial statements of Europa for the year ended 31 December 20X8.

See **Answer** at the end of this chapter.

CHAPTER 9

6 IAS 34, *Interim Financial Reporting*

Section overview

IAS 34 recommends that **publicly traded entities should produce interim financial reports** and, for entities that do publish such reports, it lays down principles and guidelines for their production.

The following definitions are used in IAS 34.

Definitions

Interim period: A financial reporting period shorter than a full financial year.

Interim financial report: A financial report containing either a complete set of financial statements (as described in IAS 1) or a set of condensed financial statements (as described in this standard) for an interim period.

6.1 Scope of IAS 34

IAS 34 does not make the preparation of interim financial reports **mandatory**, taking the view that this is a matter for governments, securities regulators, stock exchanges or professional accountancy bodies to decide within each country. The IASB does, however, strongly recommend to governments and regulators that interim financial reporting should be a requirement for companies whose equity or debt securities are **publicly traded**.

IAS 34 encourages publicly traded entities:

- to provide an interim financial report for **at least the first six months of their financial year** (ie, a half year financial report); and
- to make the report **available no later than 60 days** after the end of the interim period.

Thus, a company with a year ending 31 December would be required as a minimum to prepare an interim report for the half year to 30 June and this report should be available before the end of August.

6.2 Minimum components

IAS 34 specifies the **minimum component elements** of an interim financial report as follows:

- Condensed statement of financial position

- Condensed statement of profit or loss and other comprehensive income, presented either as a single condensed statement or a statement of profit or loss and a statement showing other comprehensive income
- Condensed statement of changes in equity
- Condensed statement of cash flows
- Selected note disclosures

IAS 34 applies where an entity is required to or chooses to publish an interim financial report in accordance with IFRS Standards.

An interim report complying with IFRS Standards may be:

- a complete set of financial statements at the interim reporting date complying in full with IFRS Standards; or
- a condensed interim financial report prepared in compliance with IAS 34.

The rationale for allowing only condensed statements and selected note disclosures is that entities need not duplicate information in their interim report that is contained in their report for the previous financial year. Interim statements should **focus more on new events, activities and circumstances**.

6.3 Form and content

Where **full financial statements** are given as interim financial statements, IAS 1 should be used as a guide, otherwise IAS 34 specifies minimum contents.

The **condensed statement of financial position** should include, as a minimum, each of the major components of assets, liabilities and equity as were in the statement of financial position at the end of the previous financial year, thus providing a summary of the economic resources of the entity and its financial structure.

The **condensed statement of profit or loss and other comprehensive income** should include, as a minimum, each of the component items of total comprehensive income as were shown in the statement of profit or loss and other comprehensive income for the previous financial year, together with the earnings per share and diluted earnings per share.

The **condensed statement of cash flows** should show, as a minimum, the three major subtotals of cash flow as required in statements of cash flows by IAS 7, namely: cash flows from operating activities, cash flows from investing activities and cash flows from financing activities.

The **condensed statement of changes in equity** should include, as a minimum, each of the major components of equity as were contained in the statement of changes in equity for the previous financial year of the entity.

6.3.1 Selected explanatory notes

IAS 34 states that **relatively minor changes** from the most recent annual financial statements need not be included in an interim report. However, the notes to an interim report should include the following (unless the information is contained elsewhere in the report).

- A statement that the **same accounting policies and methods of computation** have been used for the interim statements as were used for the most recent annual financial statements. If not, the nature of the differences and their effect should be described. (The accounting policies for preparing the interim report should only differ from those used for the previous annual accounts in a situation where there has been a change in accounting policy since the end of the previous financial year, and the new policy will be applied for the annual accounts of the current financial period.)
- Explanatory comments on the **seasonality or 'cyclicality'** of operations in the interim period. For example, if a company earns most of its annual profits in the first half of the

year, because sales are much higher in the first six months, the interim report for the first half of the year should explain this fact

- The **nature and amount** of items during the interim period affecting assets, liabilities, capital, net income or cash flows, that are unusual, due to their nature, incidence or size
- The **issue or repurchase** of equity or debt securities
- Nature and amount of any **changes in estimates** of amounts reported in an earlier interim report during the financial year, or in prior financial years if these affect the current interim period
- **Dividends paid** on ordinary shares and the dividends paid on other shares
- **Segmental results** for entities that are required by IFRS 8, *Operating Segments* to disclose segment information in their annual financial statements
- Any **significant events since the end of the interim period**
- Effect of changes in the composition of the entity during the interim period including the acquisition or disposal of subsidiaries and long-term investments, restructurings and discontinued operations
- Any significant change in a **contingent liability or a contingent asset** since the date of the last annual statement of financial position

Changes in the business environment such as changes in price, costs, demand, market share and prospects for the full year should be discussed in the management discussion and analysis of the financial review.

The entity should also disclose the fact that the interim report has been produced **in compliance with**
IAS 34 on interim financial reporting.

Worked example: Disclosure

Give some examples of the type of disclosures required according to the above list of explanatory notes.

Solution

The following are examples:

- Write down of inventories to net realisable value and the reversal of such a write down
- Recognition of a loss from the impairment of property, plant and equipment, intangible assets, or other assets, and the reversal of such an impairment loss
- Reversal of any provisions for the costs of restructuring
- Acquisitions and disposals of items of property, plant and equipment
- Commitments for the purchase of property, plant and equipment
- Litigation settlements
- Corrections of fundamental errors in previously reported financial data
- Any debt default or any breach of a debt covenant that has not been corrected subsequently
- Related party transactions

Professional skills focus: Concluding, recommending and communicating

IAS 34 is concerned with communication – publicly traded entities need more information to be communicated than do private companies. While a private company would often produce management accounts, these would be for internal purposes and not communicated to the public.

6.4 Periods covered

The standard requires that interim financial reports should provide financial information for the following periods or as at the following dates.

- **Statement of financial position data** as at the end of the current interim period, and comparative data as at the end of the most recent financial year
- **Statement of profit or loss and other comprehensive income data** for the current interim period and cumulative data for the current year to date, together with comparative data for the corresponding interim period and cumulative figures for the previous financial year
- **Statement of cash flows data** should be **cumulative** for the current year to date, with comparative cumulative data for the corresponding interim period in the previous financial year
- **Data for the statement of changes in equity** should be for both the current interim period and for the year to date, together with comparative data for the corresponding interim period, and cumulative figures, for the previous financial year

6.5 Materiality

Materiality should be assessed in relation to the interim period financial data. It should be recognised that interim measurements **rely to a greater extent on estimates** than annual financial data.

6.6 Recognition and measurement principles

A large part of IAS 34 deals with recognition and measurement principles, and guidelines as to their practical application. The **guiding principle** is that an entity should use the **same recognition and measurement principles in its interim statements as it does in its annual financial statements**.

This means, for example, that a cost that would not be regarded as an asset in the year-end statement of financial position should not be regarded as an asset in the statement of financial position for an interim period. Similarly, an accrual for an item of income or expense for a transaction that has not yet occurred (or a deferral of an item of income or expense for a transaction that has already occurred) is inappropriate for interim reporting, just as it is for year-end reporting.

Applying this principle of recognition and measurement may result, in a subsequent interim period or at the yearend, in a **remeasurement** of amounts that were reported in a financial statement for a previous interim period. **The nature and amount of any significant remeasurements should be disclosed**.

6.6.1 Revenues received occasionally, seasonally or cyclically

Revenue that is received as an occasional item, or within a seasonal or cyclical pattern, should not be anticipated or deferred in interim financial statements, if it would be inappropriate to anticipate or defer the revenue for the annual financial statements. In other words, the principles of revenue recognition should be applied consistently to the interim reports and year-end reports.

6.6.2 Costs incurred unevenly during the financial year

These should only be anticipated or deferred (ie, treated as accruals or prepayments) if it would be appropriate to anticipate or defer the expense in the annual financial statements. For example, it would be appropriate to anticipate a cost for property rental where the rental is paid in arrears, but it would be inappropriate to anticipate part of the cost of a major advertising campaign later in the year, for which no expenses have yet been incurred.

The standard goes on, in an appendix, to deal with **specific applications** of the recognition and measurement principles. Some of these examples are explained below, by way of explanation and illustration.

6.6.3 Payroll taxes or insurance contributions paid by employers

In some countries these are assessed on an annual basis, but paid at an uneven rate during the course of the year, with a large proportion of the taxes being paid in the early part of the year, and a much smaller proportion paid later on in the year. In this situation, it would be appropriate to use an estimated average annual tax rate for the year in an interim statement, not the actual tax paid. This treatment is appropriate because it reflects the fact that the taxes are assessed on an annual basis, even though the payment pattern is uneven.

6.6.4 Cost of a planned major periodic maintenance or overhaul

The cost of such an event later in the year must not be anticipated in an interim financial statement **unless** there is a legal or constructive obligation to carry out this work. The fact that a maintenance or overhaul is planned and is carried out annually is not of itself sufficient to justify anticipating the cost in an interim financial report.

6.6.5 Other planned but irregularly occurring costs

Similarly, these costs, such as charitable donations and employee training costs, should not be accrued in an interim report. These costs, even if they occur regularly and are planned, are nevertheless discretionary.

6.6.6 Year-end bonus

A year-end bonus should not be provided for in an interim financial statement **unless** there is a constructive obligation to pay a year-end bonus (eg, a contractual obligation, or a regular past practice) and the size of the bonus can be reliably measured.

Worked example: Bonus

An entity's accounting year ends on 31 December each year and it is currently preparing interim financial statements for the half year to 30 June 20X4. It has a contractual agreement with its staff that it will pay them an annual bonus equal to 10% of their annual salary if the full year's output exceeds one million units. Budgeted output is 1.4 million units and the entity has achieved budgeted output during the first six months of the year. Annual salaries are estimated to be £100 million, with the cost in the first half year to 30 June being £45 million.

Requirement

How should the bonus be reflected in the interim financial statements?

Solution

It is probable that the bonus will be paid, given that the actual output already achieved in the year is in line with budgeted figures, which exceed the required level of output. So a bonus of £4.5 million should be recognised in the interim financial statements at 30 June 20X4.

6.6.7 Holiday pay

The same principle applies here. If holiday pay is an enforceable obligation on the employer, then any unpaid accumulated holiday pay may be accrued in the interim financial report.

6.6.8 Non-monetary intangible assets

The entity might incur expenses during an interim period on items that might or will generate non- monetary intangible assets. IAS 38, *Intangible Assets* requires that costs to generate non-monetary intangible assets (eg, development expenses) should be recognised as an expense when incurred **unless** the costs form part of an identifiable intangible asset. Costs that were initially recognised as an expense cannot subsequently be treated as part of the cost of an intangible asset instead. IAS 34 states that interim financial statements should adopt the same approach. This means that it would be inappropriate in an interim financial statement to 'defer' a cost in the expectation that it will eventually be part of a non-monetary intangible asset that has not yet been recognised: such costs should be treated as an expense in the interim statement.

6.6.9 Depreciation

Depreciation should only be charged in an interim statement on non-current assets that have been acquired, not on non-current assets that will be acquired later in the financial year.

6.6.10 Foreign currency translation gains and losses

These should be calculated by the same principles as at the financial year end, in accordance with IAS 21.

6.6.11 Tax on income

An entity will include an expense for income tax (tax on profits) in its interim statements. The **tax rate** to use should be the estimated average annual tax rate for the year. For example, suppose that in a particular jurisdiction, the rate of tax on company profits is 30% on the first £200,000 of profit and 40% on profits above £200,000. Now suppose that a company makes a profit of £200,000 in its first half year, and expects to make £200,000 in the second half year. The rate of tax to be applied in the interim financial report should be 35%, not 30%, ie, the expected average rate of tax for the year as a whole. This approach is appropriate because income tax on company profits is charged on an annual basis, and an effective annual rate should therefore be applied to each interim period.

As another illustration, suppose a company earns pre-tax income in the first quarter of the year of £30,000, but expects to make a loss of £10,000 in each of the next three quarters, so that net income before tax for the year is zero. Suppose also that the rate of tax is 30%. In this case, it would be inappropriate to anticipate the losses, and the tax charge should be £9,000 for the first quarter of the year (30% of £30,000) and a negative tax charge of £3,000 for each of the next three quarters, if actual losses are the same as anticipated.

Where the tax year for a company does not coincide with its financial year, a separate estimated weighted average tax rate should be applied for each tax year, to the interim periods that fall within that tax year.

Some countries give entities tax credits against the tax payable, based on amounts of capital expenditure or research and development, etc. Under most tax regimes, these credits are calculated and granted on an annual basis; therefore it is appropriate to include anticipated tax credits within the calculation of the estimated average tax rate for the year, and apply this rate to calculate the tax on income for the interim period.

Worked example: Taxation charge

An entity's accounting year ends on 31 December 20X4, and it is currently preparing interim financial statements for the half year to 30 June 20X4. Its profit before tax for the six month period to 30 June 20X4 is £6 million. The business is seasonal and the profit before tax for the six months to 31 December 20X4 is almost certain to be £10 million. Income tax is calculated as 25% of reported annual profit before tax if it does not exceed £10 million. If annual profit before tax exceeds £10 million the tax rate on the whole amount is 30%.

Requirement

Under IAS 34 what should the taxation charge be in the interim financial statements?

Solution

The taxation charge in the interim financial statements is based upon the weighted average rate for the year. In this case the entity's tax rate for the year is expected to be 30%. The taxation charge in the interim financial statements will be £1.8 million.

Interactive question 6: Interim financial statements

The Alshain Company's profit before tax for the six months to 30 September 20X6 was £4 million. However, the business is seasonal and profit before tax for the six months to 31 March 20X7 is almost certain to be £8 million. Profit before tax equals taxable profit for this company.

Alshain operates in a country where income tax on companies is at a rate of 25% if annual profits are below £11 million and a rate of 30% where annual profits exceed £11 million. These tax rates apply to the entire profit for the year.

Requirement

Under IAS 34, *Interim Financial Reporting*, what should be the income tax expense in Alshain's interim financial statements for the half year to 30 September 20X6?

See **Answer** at the end of this chapter.

6.6.12 Inventory valuations

Within interim reports, inventories should be valued in the same way as year-end accounts. It is recognised, however, that it will be necessary to rely more heavily on estimates for interim reporting than for year-end reporting.

In addition, it will normally be the case that the net realisable value of inventories should be estimated from selling prices and related costs to complete and dispose at interim dates.

Worked example: Inventory valuations

An entity's accounting year ends on 31 December 20X4, and it is currently preparing interim financial statements for the half year to 30 June 20X4. The price of its products tends to vary. At 30 June 20X4, it has inventories of 100,000 units, at a cost per unit of £1.40. The net realisable value of the inventories is £1.20 per unit at 30 June 20X4. The expected net realisable value of the inventories at 31 December 20X4 is £1.55 per unit.

Requirement

How should the value of the inventories be reflected in the interim financial statements?

Solution

The value of the inventories in the interim financial statements at 30 June 20X4 is the lower of cost and NRV at 30 June 20X4. This is:

100,000 × £1.20 = £120,000

6.7 Use of estimates

Although accounting information must be reliable and free from material error, it may be necessary to sacrifice some accuracy and reliability for the sake of timeliness and cost benefits. This is particularly the case with interim financial reporting, where there will be much less time to produce reports than at the financial year end. The standard therefore recognises that estimates will have to be used to a greater extent in interim reporting, to assess values or even some costs, than in year-end reporting.

An appendix to IAS 34 gives some examples of the use of estimates.

- **Inventories.** An entity might not need to carry out a full inventory count at the end of each interim period. Instead, it may be sufficient to estimate inventory values using sales margins.
- **Provisions.** An entity might employ outside experts or consultants to advise on the appropriate amount of a provision, as at the year end. It will probably be inappropriate to employ an expert to make a similar assessment at each interim date. Similarly, an entity might employ a professional valuer to revalue non-current assets at the year end, whereas at the interim date(s) the entity will not rely on such experts.
- **Income taxes.** The rate of income tax (tax on profits) will be calculated at the year end by applying the tax rate in each country/jurisdiction to the profits earned there. At the interim stage, it may be sufficient to estimate the rate of income tax by applying the same 'blended' estimated weighted average tax rate to the income earned in all countries/jurisdictions.
- **Classification of current and non-current assets and liabilities.** The investigation for classifying assets and liabilities as current and non-current may be more thorough at annual reporting dates than at interim ones.
- **Pensions.** IAS 19, *Employee Benefits* encourages the use of a professionally qualified actuary in the measurement of the plan's defined benefit obligations. For interim reporting purposes reliable estimates may be obtained by extrapolation of the latest actuarial valuation.
- **Contingencies.** Normally the measurement of contingencies may involve formal reports giving the opinions of experts. Expert opinions about contingencies and uncertainties relating to litigation or assessments may or may not be needed at interim dates.
- **Revaluations and fair value accounting.** Where an entity carries assets at fair value such as non- current assets in accordance with IAS 16, *Property, Plant and Equipment* or investment properties in accordance with IAS 40, *Investment Property*, it may rely on independent professional valuations at annual reporting dates, though not at interim reporting dates.
- **Intercompany reconciliations.** Intercompany balances that are reconciled at a detailed level at the year end may be reconciled at a less detailed level at the interim reporting date.
- **Specialised industries.** Interim period measurement in specialised industries may be less precise than at year end due to their complexity, and the cost and time investment that is required.
- **Impairment.** Any impairment losses recognised in an interim financial statement must not be reversed in subsequent interim or annual financial statements.

The principle of **materiality** applies to interim financial reporting, as it does to year-end reporting. In assessing materiality, it needs to be recognised that interim financial reports will rely more heavily on estimates than year-end reports. Materiality should be assessed in relation to the interim financial statements themselves, and should be independent of 'annual materiality' considerations.

6.8 IFRS 13, amendments

IFRS 13, *Fair Value Measurement* amended IAS 34, requiring interim reports to make the disclosures required by paragraphs 91–93(h), 94–96, 98 and 99 of IFRS 13, *Fair Value Measurement* and paragraphs 25, 26 and 28–30 of IFRS 7, *Financial Instruments: Disclosures*.

7 IFRS 14, *Regulatory Deferral Accounts*

Section overview

- IFRS 14, *Regulatory Deferral Accounts* permits entities adopting IFRS for the first time to continue to account, with some limited changes, for 'regulatory deferral account balances' in accordance with their previous GAAP, both on initial adoption of IFRS and in subsequent financial statements.
- Regulatory deferral account balances, and movements in them, are presented separately in the statement of financial position and statement of profit or loss and other comprehensive income. Specific disclosures are required.

IFRS 14, *Regulatory Deferral Accounts* was issued in January 2014 and is effective for an entity's first annual IFRS financial statements for a period beginning on or after 1 January 2016. IFRS 14 is an interim standard, applicable to first-time adopters of IFRS that provide goods or services to customers at a price or rate that is subject to rate regulation by the Government eg, the supply of gas or electricity.

The following definitions are used in IFRS 14.

Definitions

Rate regulation: A framework for establishing the prices that can be charged to customers for goods and services and that framework is subject to oversight and/or approval by a rate regulator.

Rate regulator: An authorised body that is empowered by statute or regulation to establish the rate or range of rates that bind an entity.

Regulatory deferral account balance: The balance of any expense (or income) account that would not be recognised as an asset or a liability in accordance with other Standards, but that qualifies for deferral because it is included, or is expected to be included, by the rate regulator in establishing the rate(s) that can be charged to customers.

7.1 Objective

The objective of IFRS 14 is to specify the financial reporting requirements for 'regulatory deferral account balances' that arise when an entity provides goods or services to customers at a price or rate that is subject to rate regulation.

7.2 Scope of IFRS 14

IFRS 14 is permitted, but not required, to be applied where an entity conducts rate-regulated activities and has recognised amounts in its previous GAAP financial statements that meet the definition of 'regulatory deferral account balances' (sometimes referred to as 'regulatory assets' and 'regulatory liabilities').

7.3 Main issues

Rate regulation is a means of ensuring that specified costs are recovered by the supplier, and that prices charged to customers are fair. These twin objectives mean that prices charged to customers at a particular time do not necessarily cover the costs incurred by the supplier at that time. In this case, **the recovery of such costs is deferred and they are recognised through future sales**.

This leads to a mismatch. IFRS does not have specific requirements in respect of accounting for this mismatch. However, established practice is that amounts are recognised in profit or loss as they arise.

In some jurisdictions, however, local GAAP allows or requires a supplier of rate-regulated activities to recognise costs to be recovered either as a separate regulatory deferral account or as part of the cost of a related asset.

The IASB is currently working on a comprehensive project to address this issue, but the project is not complete. In the meantime, IFRS 14 permits first-time adopters of IFRS to **continue to recognise amounts related to rate regulation in accordance with their previous GAAP** when they adopt IFRS. This is effected through an exemption from paragraph 11 of IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors,* which generally requires an entity to consider the requirements of IFRS Standards dealing with similar matters and the requirements of the *Conceptual Framework* when setting its accounting policies.

An entity may change its policy for regulatory deferral accounts in accordance with IAS 8, but only if the change makes the financial statements more relevant and reliable to users.

7.4 Presentation

The amounts of regulatory deferral account balances are separately presented in an entity's financial statements.

7.5 Disclosures

Specific disclosures are required in order to enable users to assess:

- the nature of, and risks associated with, the rate regulation that establishes the price(s) the entity can charge customers for the goods or services it provides; and
- the effects of rate regulation on the entity's financial statements.

8 Audit focus – general issues with reporting performance

Section overview

The auditor must consider the risk of fraud in general, and the risk of creative accounting in particular, when auditing financial performance.

ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with the International Standards on Auditing* states the auditor's overall objectives as follows:

- To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework

- To report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor's findings

(ISA 200.11)

Note that the auditor is concerned with material misstatements arising both as a result of **error**, and as a result of **fraud**.

We looked at creative accounting, a form of fraudulent financial reporting, in Chapter 5. We will look at the audit approach to fraud and creative accounting in more detail in Chapter 24.

Another point which is worth drawing out is the need for the auditor to report and communicate **as required by the ISAs**. As ISA 200 makes clear, **the auditor must fully understand and comply with all the ISAs relevant to the audit**.

9 Audit focus – specific issues

Section overview

This section looks at some of the audit issues related to certain financial reporting treatments covered earlier in this chapter.

9.1 Presentation and disclosure of segment information

ISA 501, *Audit Evidence – Specific Considerations for Selected Items* governs the auditor's approach to auditing segment information.

Auditors are required to obtain sufficient, appropriate audit evidence regarding the presentation and disclosure of segment information by:

(a) obtaining an understanding of the methods used by management in determining segment information:
   - evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework,
   - where appropriate, testing the application of such methods; and

(b) performing analytical procedures or other audit procedures appropriate in the circumstances.

(ISA 501.13)

When the ISA talks about obtaining an understanding of management's methods, the following may be relevant:

- Sales, transfers and charges between segments, elimination of inter-segment amounts
- Comparisons with budgets and other expected results; for example, operating profits as a percentage of sales
- Allocations of assets and costs among segments
- Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies

It is important to stress that **auditors only have a responsibility in relation to the financial statements taken as a whole**. Auditors are not required to express an opinion on the segment information presented on a standalone basis.

9.2 Held-for-sale assets

As we have seen above, IFRS 5 requires that assets which meet the criteria 'held for sale' are shown **at the lower of carrying amount and fair value less costs to sell**, that held-for-sale assets are **classified separately** on the statement of financial position and the results of discontinued operations are presented separately on the statement of profit or loss and other comprehensive income.

Audit procedures to ensure assets meet the criteria include the following:

- Make enquiries/obtain written representations from management concerning intentions
- Review minutes of management for evidence of firm plan to sell
- Ascertain whether appropriate estate agent appointed (by reviewing contract between the parties)
- Review sale particulars
- Comparison of sale price per sale particulars to fair value
- Confirm likelihood of completion within a year by asking estate agent

Interactive question 7: Audit procedures – held-for-sale assets

Robinson Ltd has a balance of £250,000 in respect of assets classified as held for sale in the financial statements for the year ended 31 December 20X7.
This is in respect of two assets as follows:

- £70,000 relates to production machinery used for a product which is to be withdrawn. Production will be run down until the end of January 20X8 so that outstanding orders can be completed. The plant will then be serviced and uninstalled in early February.
- £180,000 relates to a piece of land which was classified as held for sale on 1 October. (You should assume that the IFRS 5 criteria are satisfied.) On this date the land's fair value was estimated to be £210,000 with costs to advertise the asset as being available for sale estimated at £6,000. The £180,000 represents the carrying value of the land on the basis that it is lower than fair value less costs to sell. Robinson Ltd has adopted a revaluation policy for land.

Requirements

Do the following for each of the above assets:

(a) Identify the key audit issue

(b) State the audit procedures which would be performed to address this issue

See **Answer** at the end of this chapter.

9.3 Related parties

Related parties are often involved in cases of **fraudulent financial reporting**, as highlighted in many major corporate scandals. Transactions with related parties provide scope for distorting financial information in financial statements and hiding the economic substance of transactions or fraud in companies.

The overall aim of ISA 550, *Related Parties* is to enhance the auditor's consideration of related parties and related party transactions with a focus on risk assessment, including the recognition of fraud risk factors. The firm must establish an approach that requires the auditor to assess the risks of misstatement and design audit procedures to address these. In particular, the ISA includes the following:

- Clearer responsibilities for the auditor, with a distinction being made between circumstances where the accounting framework includes disclosure and other reporting requirements for related parties, and circumstances where either there are no such requirements or they are inadequate

- Clearer distinction between the risk assessment procedures and the further audit procedures
- A definition of a related party, which is to be used as a minimum level for audit purposes where the applicable financial reporting framework establishes minimal or no related party requirements

9.4 Related parties: key issues

Readers of financial statements normally assume that transactions reflected in financial statements are made with **independent parties** unless told otherwise.

Readers will also normally assume that a company is owned by a number of shareholders and is **not subject to control or significant influence** by any one person or company unless told otherwise, eg, through disclosure of the identity of the parent company and significant shareholdings disclosure.

Where a company does business with 'related parties', for instance with shareholders or directors, these assumptions may not be valid.

9.5 The audit of related parties

9.5.1 Scope

ISA 550 provides guidance on the auditor's responsibilities, and audit procedures regarding related parties and transactions with such parties.

ISA 550 is applicable whether or not IAS 24, *Related Party Disclosures* is a requirement of the reporting framework for the entity concerned. **ISA 550, therefore, applies to private companies as well as listed companies.** ISA 550 provides the following definition.

Definition

Related party: A party that is either:

(a) a related party as defined in the applicable financial reporting framework; or

(b) where the applicable financial reporting framework establishes minimal or no related party requirements:

(1) a person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;

(2) another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or

(3) another entity that is under common control with the reporting entity through having:

- common controlling ownership;
- owners who are close family members; or
- common key management.

However, entities that are under common control by a state (ie, a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

(ISA 550.10)

9.5.2 Responsibilities

Management is responsible for the identification of related parties and the disclosure of transactions with such parties. Management should set up **appropriate internal controls** to ensure that related parties are identified and disclosed along with any related party transactions.

It may not be self-evident to management whether a party is related. Furthermore, many accounting systems are not designed to either distinguish or summarise related party transactions, so management will have to carry out additional analysis of accounting information.

The auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for or disclose related party relationships, transactions or balances.

9.5.3 Risks

The following **audit risks** may arise from a failure to identify a related party.

- Failure of the financial statements to comply with IAS 24.
- There may be a misstatement in the financial statements – transactions may be on a non arm's length basis and thus may result in assets, liabilities, profit or loss being overstated or understated. For example, special tax rates may apply to profits reported on sales to related parties.
- The reliance on a source of audit evidence may be misjudged. An auditor may rely on what is perceived to be third-party evidence when in fact it is from a related party. More generally, reliance on management assurances may be affected if the auditor were made aware of non- disclosure of a related party.
- The motivations of related parties may be outside normal business motivations and thus may be misunderstood by the auditor if there is non-disclosure. In the extreme, this may amount to fraud.

The inherent risk linked to related party transactions (RPT) can be high, especially where management is **unaware** of the existence of all the related party relationships or transactions, or where there is an opportunity for collusion, concealment or manipulation by management. There is an increased risk that the auditor may fail to detect a RPT, where:

- there has been no charge made for a RPT (ie, a zero cost transaction);
- disclosure would be sensitive for directors or have adverse consequences for the company;
- the company has no formal system for detecting RPTs;
- RPTs are with a party that the auditor could not reasonably expect to know is a related party;
- RPTs from an earlier period have remained as an unsettled balance;
- management have concealed, or failed to disclose fully, related parties or transactions with such parties; and
- the corporate structure is complex.

Note: The term 'arm's length' continues to be used in the context of IAS 24 even though it has been removed from the definition of fair value in IFRS 13.

9.5.4 Risk assessment procedures

In planning the audit, the auditor needs to consider **the risk of undisclosed related party transactions**. This is a difficult area because IAS 24 does not have consideration for materiality. Thus, even small RPTs should be disclosed by a company. Indeed, related party relationships where there is control (eg, a subsidiary) need to be disclosed even where there are no transactions with this party.

The auditor needs to perform the following procedures:

(a) The engagement team shall discuss the risks of fraud-related misstatements.

Matters to be addressed would include the importance of maintaining professional scepticism and circumstances which may indicate the existence of related party relationships or transactions that management has not identified.

(b) Make inquiries of management about the identities of related parties and any RPTs. This includes:

(1) the identity of related parties, including changes from prior period;

(2) the nature of the relationships between the entity and its related parties;

(3) whether any transactions occurred between the parties and, if so;

(4) what controls the entity has to identify, account for and disclose related party relationships and transactions;

(5) what controls the entity has to authorise and approve significant transactions and arrangements with related parties; and

(6) what controls the entity has to authorise and approve significant transactions and arrangements outside the normal course of business.

(c) Obtain an understanding of controls established to identify, account for and disclose RPTs and to authorise and approve significant transactions with related parties / outside the normal course of business.

Where controls are ineffective or non-existent, the auditor may be unable to obtain sufficient, appropriate audit evidence and will need to consider the impact of this on the audit opinion.

The auditor is also required to be alert for related party information when reviewing records or documents. In particular, the auditor must inspect bank and legal confirmations and minutes of meetings of the shareholders and those charged with governance. Where these procedures reveal significant transactions outside the entity's normal course of business, the auditor must inquire of management about the nature of these transactions and whether a related party could be involved.

9.5.5 Responses to the risks of material misstatement

In accordance with ISA 330, the auditor must design and perform further audit procedures to obtain sufficient, appropriate evidence about the assessed risks of material misstatement. These may include:

- confirming or discussing the transactions with intermediaries eg, banks, lawyers or agents;
- confirming the purposes, specific terms or amounts of the transaction with the related party; and
- reading the financial statements of the related party for evidence of the transaction in the related party's accounting records.

Where the risk of misstatement may be due to fraud additional procedures may apply:

- Inquiries of and discussion with management and those charged with governance
- Inquiries of the related party
- Inspection of significant contracts with the related party
- Background research eg, internet
- Review of employee whistleblowing reports

Identification of previously unidentified or undisclosed related parties or significant related party transactions

If the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor, the auditor must do the following:

- Promptly communicate the relevant information to the other members of the engagement team
- Where the applicable reporting framework establishes related party requirements request management to identify all transactions with the newly identified related parties and inquire as to why the entity's controls have failed to identify and disclose the transaction
- Perform appropriate substantive audit procedures

These might include making inquiries regarding the nature of the entity's relationships with the newly identified related party, conducting an analysis of accounting records for transactions with the newly identified related party and verifying the terms and conditions of the newly identified related party transaction

- Reconsider the risk that other unidentified related parties or significant related party transactions may exist
- If the non-disclosure by management appears intentional and therefore indicates possible fraud evaluate the implications for the rest of the audit

Identified significant related party transactions outside the entity's normal course of business

Where significant related party transactions outside the entity's normal course of business are identified, the auditor must do the following:

- Inspect the underlying contracts and agreements and evaluate whether:
  - the business rationale or lack of suggests fraud;
  - the terms are consistent with the management's explanations; and
  - the transaction has been appropriately accounted for and disclosed.
- Obtain audit evidence that transactions have been appropriately authorised and approved

Management assertions

If management has made assertions in the financial statements to the effect that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction, the auditor must obtain evidence to support this. The nature of the evidence obtained will depend on the support management has obtained to substantiate their claim but may involve:

- considering the appropriateness of management's process for supporting the assertion;
- verifying the source of internal and external data supporting the assertion and testing it for accuracy, completeness and relevance; and
- evaluating the reasonableness of any significant assumptions on which the assertion is based.

9.5.6 Evaluation of accounting and disclosure

The auditor is required to evaluate whether related parties and related party transactions have been properly accounted for and disclosed and do not prevent the financial statements from achieving fair presentation.

9.5.7 Written representations

The auditor is required to obtain written representations from management and, where appropriate, those charged with governance that all related parties and related party transactions have been disclosed to the auditor and that these have been appropriately accounted for and disclosed.

An entity may require its management and those charged with governance to sign individual declarations in relation to related party matters. It may be helpful if any such declarations are addressed jointly to a designated official of the entity and also to the auditor.

9.5.8 Documentation

The auditor is required to include in the audit documentation the identity of related parties and the nature of related party relationships.

Note: The law regarding transactions with directors was covered in earlier Chapter of this Workbook.

9.6 Related parties: practical application

The following five point action plan can be used for auditing related parties:

- Plan your work on the audit of related party relationships and transactions thoroughly.
- Focus on the risk of material misstatement that might arise from related party transactions.
- Understand the internal controls at the company to identify related parties and to record related party transactions.
- Design procedures to respond to risks identified.
- Perform completion procedures.

9.6.1 Identifying undisclosed related parties

It is often difficult to identify related party relationships and transactions which should have been disclosed, but are not.

ISA 550 points out that the existence of the following relationships may indicate the presence of control or significant influence:

(a) Direct or indirect equity holdings or other financial interests in the entity

(b) The entity's holdings of direct or indirect equity or other financial interests in other entities

(c) Being part of those charged with governance or key management (that is, those members of management who have the authority and responsibility for planning, directing and controlling the activities of the entity)

(d) Being a close family member of any person referred to in subparagraph (c)

(e) Having a significant business relationship with any person referred to in subparagraph (c)

The related parties described in subparagraph (c) above, and by extension those described in (d) and (e), are often the hardest to identify. While entities related through equity interest should be fairly clearly documented, auditors frequently struggle to identify related party transactions established through connected persons.

The following risk assessment procedures are relevant when testing for the existence of undisclosed related parties:

- **Enquire of management** and the directors as to whether transactions have taken place with related parties that are required to be disclosed by the disclosure requirements that are applicable to the entity
- **Review prior year working papers** for names of known related parties
- **Review minutes** of meetings of shareholders and directors and other relevant statutory records, such as the register of directors' interests
- **Review accounting records** for large or unusual transactions or balances, in particular transactions recognised at or near the end of the financial period

- **Review confirmations of loans receivable and payable** and confirmations from banks. Such a review may indicate the relationship, if any, of guarantors to the entity
- **Review investment transactions**, for example purchase or sale of an interest in a joint venture or other entity
- **Enquire** as to the **names of all pension and other trusts** established for the benefit of employees and the names of their management and trustees
- **Enquire** as to the **affiliation** of directors and officers with other entities
- **Review the register of interests in shares** to determine the names of principal shareholders
- **Enquire of other auditors** currently involved in the audit, or predecessor auditors, as to their knowledge of additional related parties
- **Review the entity's tax returns**, returns made under statute and other information supplied to regulatory agencies for evidence of the existence of related parties
- **Review invoices and correspondence from lawyers** for indications of the existence of related parties or related party transactions

9.7 First-time adoption of IFRS

Companies adopting IFRS for the first time are required to produce comparative financial statements, restating prior period figures in accordance with IFRS.

Auditing the financial statements of a company adopting IFRS for the first time poses a special challenge to the auditor, as set out in ISA 710, *Comparative Information: Corresponding Figures and Comparative Financial Statements*. We have discussed the auditing of comparatives in detail in earlier chapters.

9.7.1 Scope of the audit

Comparative financial statements refer to a **full set of financial statements for the prior period**, included in the current period's annual report. This differs from **corresponding figures**, where prior period figures are set out next to current period figures in a set of financial statements for comparison.

While the auditor does not express an opinion on corresponding figures, where comparative financial statements are issued, the auditor is required to **express an opinion on both the restated prior period and the current period**.

9.7.2 Audit procedures

ISA 710 requires the auditor to evaluate:

- Whether the comparative information agrees with the amounts and other disclosures presented in the prior period or, when appropriate, have been restated; and
- Whether the accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.

If the auditor identifies any possible misstatement, they should carry out additional audit procedures to obtain sufficient, appropriate audit evidence about whether a material misstatement actually exists.

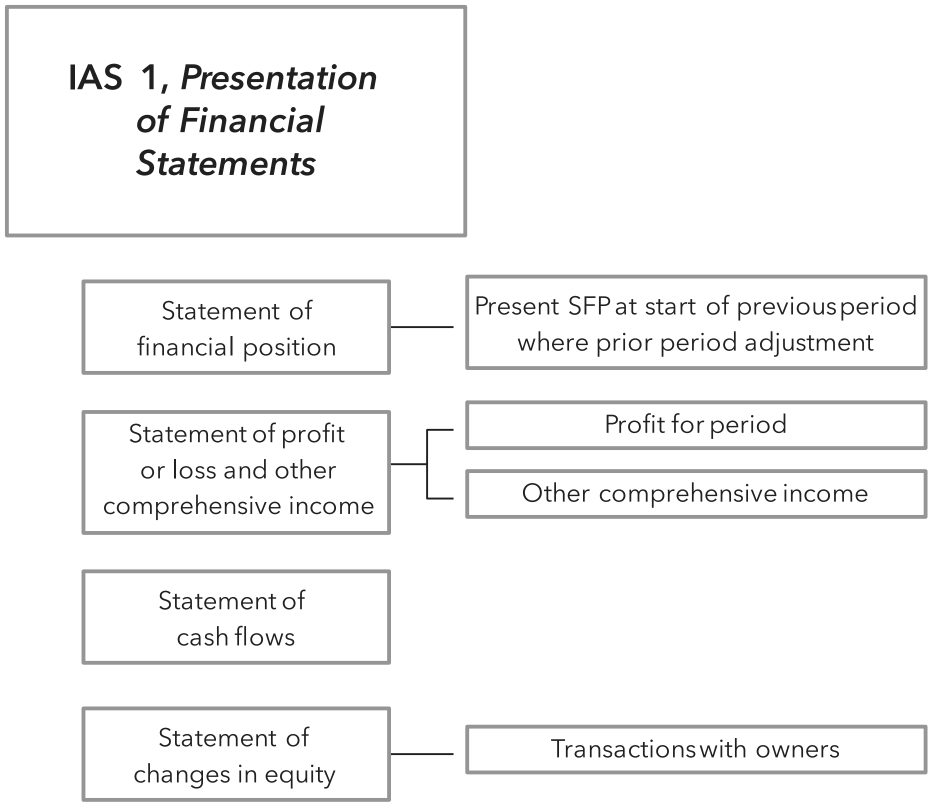
In addition, auditors must obtain **written representations** for all the periods referred to in the auditor's report. This means that written representations must be obtained for the restated period, as well as the current period.

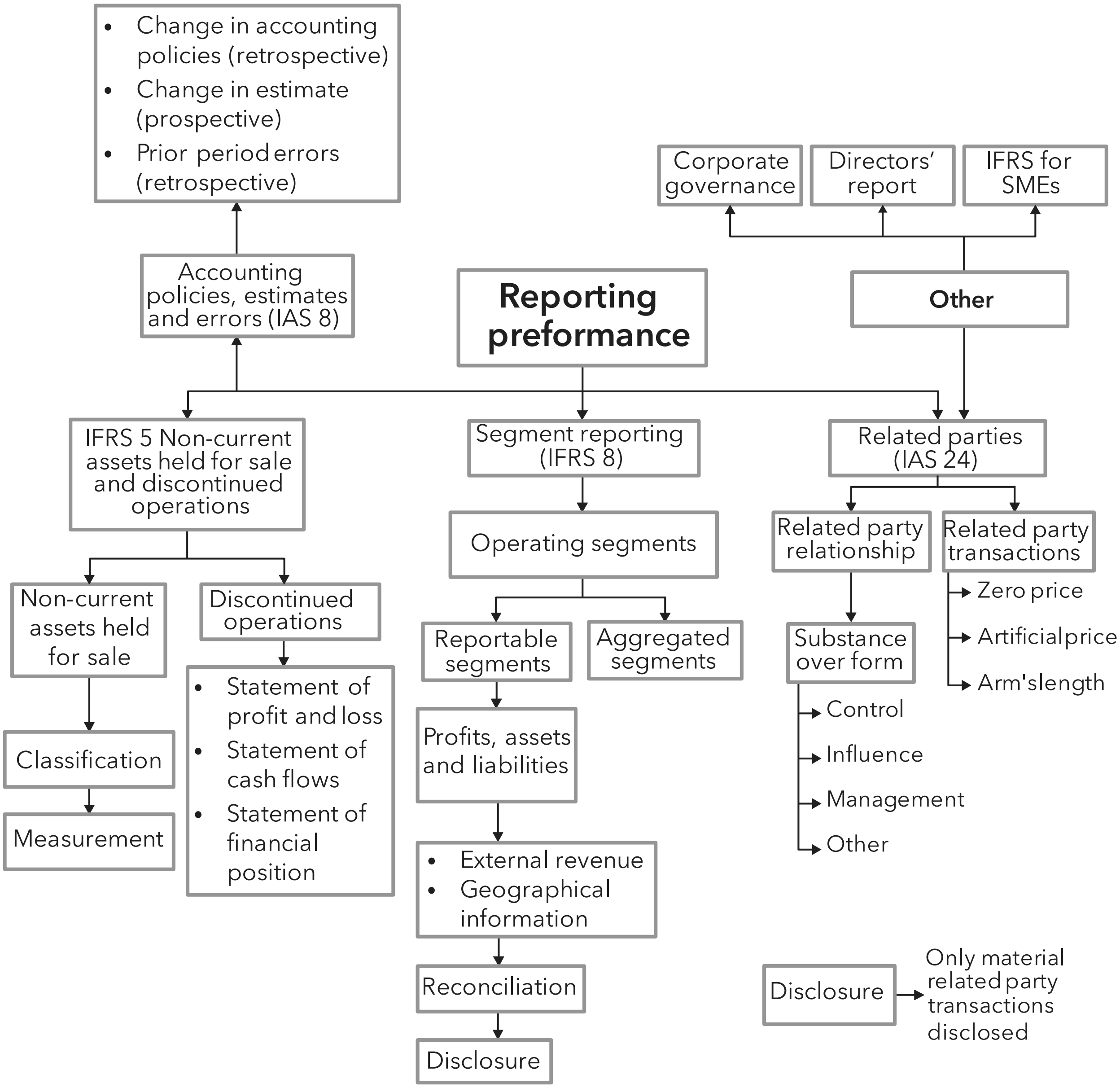
9.7.3 Audit reporting

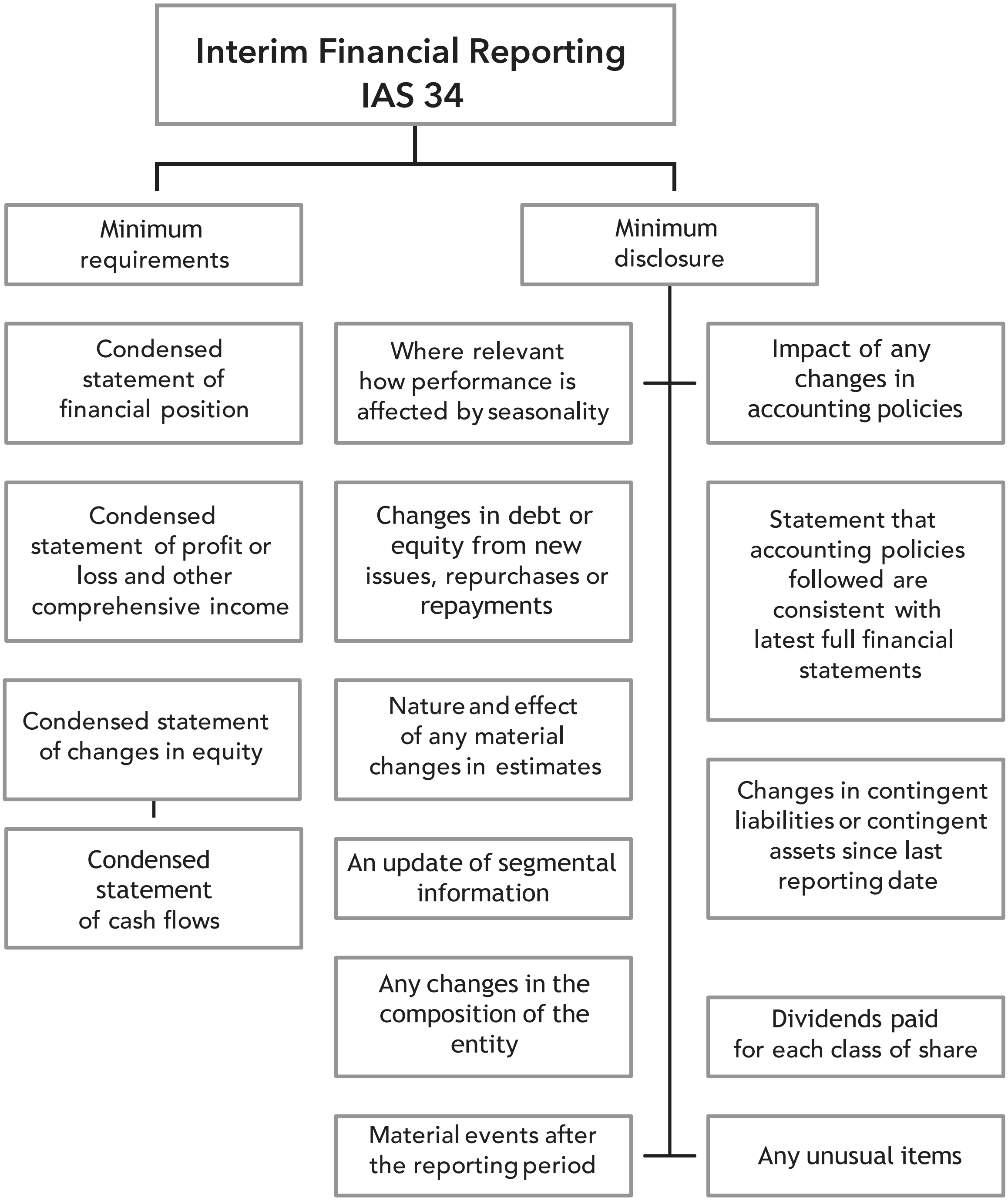
ISA 710 states that 'the auditor's opinion shall refer to each period for which the financial statements are presented'.

It is possible for different audit opinions to be expressed for each period. Where a modified audit opinion is given for the restated period, an **Other Matter** paragraph should be included, explaining the reason for the modification.

Summary


IAS 1, *Presentation of Financial Statements*
Statement of financial position
Present SFP at start of previous period where prior period adjustment
Statement of profit or loss and other comprehensive income
Profit for period
Other comprehensive income
Statement of cash flows
Statement of changes in equity
Transactions with owners


Change in accounting policies (retrospective)
Change in estimate (prospective)
Prior period errors (retrospective)
Accounting policies, estimates and errors (IAS 8)
Reporting preformance
Corporate governance
Directors' report
IFRS for SMEs
Other
IFRS 5 Non-current assets held for sale and discontinued operations
Segment reporting (IFRS 8)
Related parties (IAS 24)
Non-current assets held for sale
Discontinued operations
Classification
Measurement
Statement of profit and loss
Statement of cash flows
Statement of financial position
Operating segments
Reportable segments
Aggregated segments
Profits, assets and liabilities
External revenue
Geographical information
Reconciliation
Disclosure
Related party relationship
Related party transactions
Substance over form
Control
Influence
Management
Other
Zero price
Artificial price
Arm'slength
Disclosure
Only material related party transactions disclosed


Interim Financial Reporting
IAS 34
Minimum requirements
Minimum disclosure
Condensed statement of financial position
Condensed statement of profit or loss and other comprehensive income
Condensed statement of changes in equity
Condensed statement of cash flows
Where relevant how performance is affected by seasonality
Changes in debt or equity from new issues, repurchases or repayments
Nature and effect of any material changes in estimates
An update of segmental information
Any changes in the composition of the entity
Material events after the reporting period
Impact of any changes in accounting policies
Statement that accounting policies followed are consistent with latest full financial statements
Changes in contingent liabilities or contingent assets since last reporting date
Dividends paid for each class of share
Any unusual items

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Do you understand the IAS 1 rules on presenting comparatives? (Topic 1)
2.	Do you understand what is meant by an operating segment? (Topic 3)
3.	Can you measure assets held for sale as per IFRS 5? (Topic 4)
4.	What are the minimum components of interim financial statements under IFRS 34? (Topic 7)
5.	Do you understand the role of the auditor in relation to segment information? (Topic 10)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
AZ	This is a very good question to revise your knowledge of IAS 1 and preparation of financial statements, which you covered at Professional Level.
Ndombe	This tests IFRS 5, specifically classifying and valuing non-current assets held for sale. This should be assumed knowledge from earlier studies, but if you struggle you may need to go back to your earlier study material.
Mareotis	This is a comprehensive question on related parties, an area that could be tested as part of a longer question.

Once you have attempted the self-test questions, you can continue your studies by moving onto the next chapter. In later chapters, we will recommend questions from the Question Bank for you to attempt.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving on to the next chapter.

Technical reference

1 **IFRS 8, *Operating Segments***

- Requires an entity to report its operating segments based on the data reported **internally to management**. Geographical disclosures of **external revenue** and **non-current assets** are also required. – **IFRS 8 Paragraph 20–22**
- The minimum disclosure is of **profit/loss** by segment.
- Geographical disclosures of **external revenue** and **non-current assets** are also required.

2 **IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations***

- Discontinued operations
- Definition – **IFRS 5.31–32**
- Disclosures on the face of the statement of profit or loss and other comprehensive income: – **IFRS 5.33(a)**
- A single amount comprising the total of:
  - The post-tax profit or loss of discontinued operations, and
  - The post-tax gain or loss recognised on related assets
- Disclosures on the face or in the notes – **IFRS 5.33(b) (c)**
- An analysis of the single amount on the face
- Comparative figures must be restated – **IFRS 5.34**
- Narrative disclosures are also required – **IFRS 5.41**

3 **IAS 24, *Related Party Disclosures***

- Definition of a related party and related party transaction – **IAS 24.9**
- Exclusions from definition of related party – **IAS 24.11**
- Disclosures – **IAS 24.12, 16, 17, 18**

4 **IFRS 1, *First-time Adoption of International Financial Reporting Standards***

- Opening IFRS SOFP – **IFRS 1.6**
- Accounting policies – **IFRS 1.7–12**
- Estimates – **IFRS 1.23-33**
- Transition process – **IFRS 1 App C,D**
- Exemptions – **IFRS 1.20–33**
- Disclosure

5 **IAS 34, *Interim Financial Reporting***

- Minimum components of an interim financial report – **IAS 34.8**
- Form and content of interim financial statements – **IAS 34.9–11**
- Selected explanatory notes – **IAS 34.16**
- Disclosure of compliance with IFRS Standards – **IAS 34.19**
- Periods for which interim financial statements are required to be presented – **IAS 34.20**
- Materiality – **IAS 34.23**

6 **IAS 1, *Presentation of Financial Statements***

- Applies to all general purpose financial statements
- Links back to much in the IASB Framework
- Presentation and disclosure rules apply only to material items – **IAS 1.31 and IAS 1.7**
- Statement of financial position – **IAS 1.54, 56, 60, 66, 69, 79**

7 **Disclosure in annual financial statements**

- If an estimate of an amount reported in an interim period is changed significantly during the final interim period of the financial year but a separate financial report is not published for that final interim period, the nature and amount of that change in estimate shall be disclosed in a note to the annual financial statements for that financial year. – **IAS 34.26**

8 **Recognition and measurement**

- An entity should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an entity's reporting (annual, half-yearly, or quarterly) should not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes should be made on a year-to-date basis. – **IAS 34.28**

9 **Revenues received seasonally, cyclically, or occasionally**

- Revenues that are received seasonally, cyclically, or occasionally within a financial year shall not be anticipated or deferred as of an interim date if anticipation or deferral would not be appropriate at the end of the entity's financial year. – **IAS 34.37**

10 **Costs incurred unevenly during the financial year**

- Costs that are incurred unevenly during an entity's financial year shall be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year. – **IAS 34.39**
- Applying the recognition and measurement principles – **IAS 34.40**
- Use of estimates – **IAS 34.41**
- Restatement of previously reported interim periods – **IAS 34.43**

11 **IFRS 14, *Regulatory Deferral Accounts***

- Specifies the financial reporting requirements for 'regulatory deferral account balances' that arise when an entity provides goods or services to customers at a price or rate that is subject to rate regulation. – **IFRS 14.1**
- Eligible entities can continue to apply the accounting policies used for regulatory deferral account balances under the basis of accounting used immediately before adopting IFRS ('previous GAAP') when applying IFRS Standards, subject to the presentation requirements of IFRS 14. – **IFRS 14.11**
- The impact must be presented separately. – **IFRS 14.20**
- Specific disclosures are required. – **IFRS 14.27**

12 **ISA 501**

- Audit of segment information – **ISA 501.13**

13 ISA 550

- Definition of related parties – **ISA 550.10**
- Auditor's responsibilities in relation to related parties – **ISA 550.3–7**
- Audit procedures in respect of related parties – **ISA 550.11–28**

14 ISA 710

- Audit procedures in respect of comparative financial statements – **ISA 710.7–9**
- Audit reporting in respect of comparative financial statements – **ISA 710.10–19**

Self-test questions

Answer the following questions.

1 AZ

AZ is a quoted manufacturing company. Its finished products are stored in a nearby warehouse until ordered by customers. AZ has performed very well in the past, but has been in financial difficulties in recent months and has been reorganising the business to improve performance.

The trial balance for AZ at 31 March 20X3 was as follows:

	$'000	**$'000**
Sales		124,900
Cost of goods manufactured in the year to 31 March 20X3 (excluding depreciation)	94,000	
Distribution costs	9,060	
Administrative expenses	16,020	
Restructuring costs	121	
Interest received		1,200
Loan note interest paid	639	
Land and buildings (including land $20,000,000)	50,300	
Plant and equipment	3,720	
Accumulated depreciation at 31 March 20X2:		
Buildings		6,060
Plant and equipment		1,670
Investment properties (at market value)	24,000	
Inventories at 31 March 20X2	4,852	
Trade receivables	9,330	
Bank and cash	1,190	
Ordinary shares of $1 each, fully paid		20,000
Share premium		430
Revaluation surplus		3,125
Retained earnings at 31 March 20X2		28,077
Ordinary dividends paid	1,000	
7% loan notes 20X7		18,250
Trade payables		8,120
Proceeds of share issue		2,400
	214,232	214,232

Additional information provided:

(1) The property, plant and equipment are being depreciated as follows:

Buildings 5% per annum straight line.

Plant and equipment 25% per annum reducing balance.

Depreciation of buildings is considered an administrative cost while depreciation of plant and equipment should be treated as a cost of sale.

(2) On 31 March 20X3 the land was revalued to $24,000,000.

(3) Income tax for the year to 31 March 20X3 is estimated at $976,000. Ignore deferred tax.

(4) The closing inventories at 31 March 20X3 were $5,180,000. An inspection of finished goods found that a production machine had been set up incorrectly and that several production batches, which had cost $50,000 to manufacture, had the wrong packaging. The goods cannot be sold in this condition but could be repacked at an additional cost of $20,000. They could then be sold for $55,000. The wrongly packaged goods were included in closing inventories at their cost of $50,000.

(5) The 7% loan notes are 10-year loans due for repayment by 31 March 20X7. Interest on these loan notes needs to be accrued for the six months to 31 March 20X3.

(6) The restructuring costs in the trial balance represent the cost of a major restructuring of the company to improve competitiveness and future profitability.

(7) No fair value adjustments were necessary to the investment properties during the period.

(8) During the year the company issued 2 million new ordinary shares for cash at $1.20 per share. The proceeds have been recorded as 'Proceeds of share issue'.

Requirement

Prepare the statement of profit or loss and other comprehensive income and statement of changes in equity for AZ for the year to 31 March 20X3 and a statement of financial position at that date.

Notes to the financial statements are not required, but all workings must be clearly shown.

2 Viscum

The Viscum Company accounts for non-current assets using the cost model.

On 25 April 20X6 Viscum classified a non-current asset as held for sale in accordance with IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*. At that date the asset's carrying amount was £30,000, its fair value was estimated at £22,000 and the costs to sell at £3,000.

On 15 May 20X6 the asset was sold for net proceeds of £18,400.

Requirement

In accordance with IFRS 5, what amount should be included as an impairment loss in Viscum's financial statements for the year ended 30 June 20X6?

3 Reavley

The Reavley Company accounts for non-current assets using the cost model.

On 20 July 20X6 Reavley classified a non-current asset as held for sale in accordance with IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*. At that date the asset's carrying amount was £19,500, its fair value was estimated at £26,500 and the costs to sell at £1,950.

The asset was sold on 18 October 20X6 for £26,000.

Requirement

In accordance with IFRS 5, at what amount should the asset be stated in Reavley's statement of financial position at 30 September 20X6?

4 Smicek

The Smicek Company classified an asset as being held for sale on 31 December 20X6. The asset had been purchased for a cost of £1.2 million on 1 January 20X4, and then had a 12-year useful life. On 31 December 20X6 its carrying amount was £900,000, its fair value was £860,000 and the expected sale costs were £20,000.

On 31 December 20X7 the board of Smicek, having failed to sell the asset during 20X7, decided to reverse their original decision and therefore use the asset in the business. At 31 December 20X7 the asset had a fair value of £810,000 and expected sale costs of £20,000. The directors estimate that annual cash flows relating to the asset would be £200,000 per year for the next 6 years. The effect of discounting is not material.

Requirement

What is the effect on profit or loss of Smicek's ceasing to classify the asset as held for sale, according to IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*?

5 Ndombe

The Ndombe Company classified a group of assets as held for sale on 31 December 20X6. Their fair value less costs to sell was £1,180,000.

During 20X7 the company decided that one of the assets, a polishing machine, should no longer be treated as an asset held for sale. The sale of the other assets was delayed due to events beyond the control of Ndombe and the company remains committed to their sale, which is highly probable in 20X8.

Asset values and dates are as follows:

	Polishing machine	**Other assets**
	£	**£**
Cost at 1 January 20X5	400,000	1,500,000
Accumulated depreciation to 31 December 20X6	(160,000)	(600,000)
Carrying amount on 31 December 20X6	240,000	900,000
Useful life	5 years	5 years
Fair value less costs to sell 31 December 20X6	210,000	970,000
Fair value less costs to sell 31 December 20X7	190,000	880,000
Value in use at 31 December 20X7	170,000	810,000

Requirement

Under IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations* what are the amounts that should be shown under assets on the statement of financial position at 31 December 20X6 and 31 December 20X7?

6 Sapajou

The Sapajou Company bought a property with a useful life of 10 years for £1,200,000 on 1 January 20X4.

On 1 July 20X6 the board of Sapajou made a decision to sell the property, and immediately vacated it and advertised it for sale. At this date fair value less costs to sell was estimated at £880,000.

Negotiations with a buyer appeared successful, and a sale was provisionally agreed for 1 August 20X7 for £880,000. At the last minute the buyer withdrew and Sapajou had to re-advertise the property.

A new buyer was found in November 20X7 and a new price was agreed at fair value less costs to sell of £995,000. The sale is scheduled to take place in February 20X8.

Requirement

What are the amounts that should be included in profit or loss for the years ending 31 December 20X6 and 31 December 20X7?

7 Sulafat

The Sulafat Company has a 70% subsidiary Vurta and is a venturer in Piton, a joint venture company. During the financial year to 31 December 20X6, Sulafat sold goods to both companies.

Consolidated financial statements are prepared combining the financial statements of Sulafat and Vurta.

Requirement

Which transactions should be disclosed under IAS 24, *Related Party Disclosures*, in the **separate** financial statements of Sulafat for 20X6?

8 Phlegra

In the year ended 31 December 20X7, the Phlegra Company undertook transactions with the following entities to the value stated.

(1) The Nereidum Company, one of whose non-executive directors is an executive director of Phlegra: £300,000.

(2) The Chub Company, which sources 100% of its raw materials requirements from Phlegra: £190,000.

Requirement

Under IAS 24, *Related Party Disclosures*, what is the total amount to be disclosed in respect of transactions with related parties in Phlegra's financial statements for the year ended 31 December 20X7?

9 Mareotis

The Mareotis Company is a partly owned subsidiary of the Bourne Company. In the year ended 31 December 20X7 Mareotis undertook transactions with the following entities to the value stated.

(1) The Hayles Company, in which the Wrasse Company holds 55% of the equity. Bourne holds 40% of the equity of Wrasse and has the power to appoint 3 out of the 5 members of

Wrasse's board of directors: £300,000.

(2) The Galaxius Company, which is controlled by Danielle (the aunt of Agnes, a member of Mareotis's board of directors): £500,000.

Requirement

Under IAS 24, *Related Party Disclosures*, what is the total amount of transactions with related parties to be disclosed in Mareotis's financial statements for the year ended 31 December 20X7?

10 Marmoset

The Marmoset Company offers the service of transport consultations. Its accounting year ends on 31 December each year and it is currently preparing half-yearly interim financial statements for the six months to 30 June 20X7.

During 20X7 the directors drew up a plan to introduce a new bonus scheme for all junior consultants in order to provide incentives and improve retention. The details of the scheme were announced to employees the day before the interim financial statements were released on 15 August 20X7. Under the planned scheme any bonus would be paid on 31 March 20X8.

The bonus will be equal to 1% of profit before tax (calculated before recognising the bonus) of the year ended 31 December 20X7.

The business is seasonal such that 60% of the annual profit before tax is earned in the first six months of the year. The profit before tax in the interim financial statements for the six months to 30 June 20X7 is £6 million.

Requirement

What amount should be recognised in profit or loss for Marmoset for the six months to 30 June 20X7 in respect of the bonus, according to IAS 34, *Interim Financial Reporting*?

11 Aconcagua

The Aconcagua Company sells fashion shoes, the price of which varies during the year. Its accounting year ends on 31 December and it prepares half-yearly interim financial statements.

At 30 June 20X7 it has inventories of 2,000 units which cost £30 each. The net realisable value of the inventories at 30 June, when the shoes are out of season, is £20 each. No sales are expected in the period to 31 December 20X7, but the expected net realisable value of the shoes at that date (when they are about to come back into season) is £28 each.

Requirement

Should any changes in inventory values be reflected in the interim financial statements of Aconcagua for the six months ending 30 June 20X7 and for the six months ending 31 December 20X7, according to IAS 34, *Interim Financial Reporting*?

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

IFRS 8, *Operating Segments* states that an operating segment is separately reportable if it has been identified as a separate operating segment meeting the operating segment definition, and:

- its reported revenue is 10% or more of the combined revenue (external and internal) of all operating segments, **or**
- the absolute amount of its reported profit or loss is 10% or more of the greater of the combined profit of all operating segments that did not report a loss and the combined reported loss of all operating segments that reported a loss, **or**
- its assets are 10% or more of the combined assets of all operating segments.

	Revenue as % of total revenue (£238m)	Profit or loss as % of profit of all segments in profit (£29m)	Assets as % of total assets (£336m)
Chemicals *	33.6%	48.3%	32.4%
Pharmaceuticals wholesale	28.2%	31.0%	31.0%
Pharmaceuticals retail	9.2%	6.9%	8.9%
Cosmetics	6.3%	6.9%	5.4%
Hair care	5.0%	13.8%	6.3%
Body care	17.6%	20.7%	16.1%

* The chemicals segments are aggregated due to their similar economic characteristics

At 31 December 20X5 four of the six operating segments are reportable operating segments:

Chemicals

All size criteria are met. **Pharmaceuticals wholesale** All size criteria are met.

Pharmaceuticals retail

The Pharmaceuticals retail segment is not separately reportable, as it does not meet the quantitative thresholds. It can, however, still be reported as a separate operating segment if management believes that information about the segment would be useful to users of the financial statements.

Alternatively, the group could consider amalgamating it with the Pharmaceuticals wholesale segment, providing the two operating segments have similar economic characteristics and share a **majority** of the 'aggregation' criteria which, excluding the type of customer, may be the case.

Otherwise it would be disclosed in an 'All other segments' column.

Cosmetics

The Cosmetics segment does not meet the quantitative thresholds and therefore is not separately reportable. It can also be reported separately if management believes the information would be useful to users. Alternatively the group may be able to amalgamate it with the Body care segment, providing the operating segments have similar economic characteristics and share a majority of the 'aggregation' criteria. Otherwise it would also be disclosed in an 'All other segments' column.

Hair care

The Hair care segment is separately reported due to its profitability being greater than 10% of total segments in profit.

Body care

All size criteria are met.

Note: IFRS 8.15 states that at least 75% of total external revenue must be reported by operating segments. This condition has been met, as the reportable segments account for 82% of total external revenue (158/192).

Answer to Interactive question 2

The facility will not be transferred until the backlog of orders is completed; this demonstrates that the facility is not available for immediate sale in its present condition. The facility cannot be classified as 'held for sale' at 31 December 20X3. It must be treated in the same way as other items of property, plant and equipment: it should continue to be depreciated and should not be separately disclosed.

Answer to Interactive question 3

Because the steel works is being closed, rather than sold, it cannot be classified as 'held for sale'. In addition, the steel works is not a discontinued operation. Although at 31 December 20X3 the group was firmly committed to the closure, this has not yet taken place and therefore the steel works must be included in continuing operations. Information about the planned closure could be disclosed in the notes to the financial statements.

Answer to Interactive question 4

In its financial statements S must disclose all benefits provided in exchange for services rendered to S (but not those rendered to P), whether they are provided by S, by P, or on behalf of S (as are the pension benefits and the share options). All the amounts listed should be disclosed by S, with the exception of the £20,000 payable in respect of services rendered to P.

Answer to Interactive question 5

5.1 Europa's first IFRS financial statements will be for the year ended 31 December 20X8. IFRS 1 requires that at least one year's comparative figures are presented and therefore the date of transition to IFRS Standards is the beginning of business on 1 January 20X7 (or close of business on 31 December 20X6).

Therefore the procedure for adopting IFRS Standards is:

- Identify accounting policies that comply with IFRS Standards effective at 31 December 20X8 (the reporting date for the first IFRS financial statements).
- Restate the opening statement of financial position at 1 January 20X7 (the date of transition) using these IFRS Standards retrospectively, by:
  - Recognising all assets and liabilities whose recognition is required by IFRS Standards
  - Not recognising items as assets or liabilities if IFRS Standards do not permit such recognition
  - Reclassifying items that were recognised under previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity under IFRS Standards

    - Measuring all recognised assets and liabilities in accordance with IFRS Standards

    The company will almost certainly need to change some of its accounting policies and to adjust some of the amounts that it reported previously at the same dates using previous GAAP. It should recognise these adjustments directly in retained earnings (ie, in equity).

- Explain the effect of the transition from previous GAAP to IFRS Standards, by presenting:
    - A reconciliation of equity reported under previous GAAP to equity under IFRS Standards at the date of transition and at the latest previous GAAP reporting date
    - A reconciliation of the profit or loss reported under previous GAAP to profit or loss reported under IFRS Standards for the last period presented under previous GAAP

If Europa presented a statement of cash flows under previous GAAP, it should also explain any material adjustments to the statement of cash flows.

Although the general rule is that all IFRS Standards should be applied retrospectively, a number of exemptions are available. These are intended to cover cases in which the cost of complying fully with a particular requirement would outweigh the benefits to users of the financial statements. Europa may choose to take advantage of any or all of the exemptions.

5.2 Changing from previous GAAP to IFRS Standards is likely to be a complex process and should be carefully planned. Although previous GAAP and IAS/IFRS may follow broadly the same principles, there are still likely to be many important differences in the detailed requirements of individual standards.

If Europa has foreign subsidiaries outside Molvania it will need to ensure that they comply with any previous reporting requirements. This may mean that subsidiaries have to prepare two sets of financial statements: one using their previous GAAP; and one using IFRS Standards (for the consolidation).

The process will be affected by the following:

- The differences between previous GAAP and IFRS Standards as they affect the group financial statements in practice. The company will need to carry out a detailed review of current accounting policies, paying particular attention to areas where there are significant differences between previous GAAP and IFRS Standards. These will probably include deferred tax, business combinations, employee benefits and foreign currency translation. It should be possible to estimate the effect of the change by preparing pro forma financial statements using IFRS Standards.
- The level of knowledge of IFRS Standards of current finance staff (including internal auditors). It will probably be necessary to organise training and the company may need to recruit additional personnel.
- The group's accounting systems. Management will need to assess whether computerised accounting systems can produce the information required to report under IFRS Standards. They will also need to produce new consolidation packages and accounting manuals.

Lastly, the company should consider the impact of the change to IFRS Standards on investors and their advisers. For this reason management should try to quantify the effect of IFRS Standards on results and other key performance indicators as early as possible.

5.3 **Advice**

(1) **Accounting estimates**

Estimates under IFRS Standards at the date of transition must be consistent with those made at the same date under previous GAAP (after adjustments to reflect any difference in accounting policies). The only exception to this is if the company has subsequently discovered that these estimates were in error. This is not the case here and therefore the estimates are not adjusted in the first IFRS financial statements.

(2) **Court case**

The treatment of this depends on the reason why Europa did not recognise a provision under previous GAAP at 31 December 20X7.

If the requirements of previous GAAP were consistent with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, presumably the directors concluded that an outflow of economic benefit was not probable and that the recognition criteria were not met. In this case, Europa's assumptions under IFRS Standards are consistent with its previous assumptions under previous GAAP. Europa does not recognise a provision at 31 December 20X7 and accounts for the payment in the year ended 31 December 20X8.

If the requirements of previous GAAP were not consistent with IAS 37, Europa must determine whether it had a present obligation at 31 December 20X7. The directors should take account of all available evidence, including any additional evidence provided by events after the reporting period up to the date the 20X7 financial statements were authorised for issue in accordance with IAS 10, *Events After the Reporting Period*.

5.4 The outcome of the court case confirms that Europa had a liability in September 20X7 (when the events that resulted in the case occurred), but this event occurred after the 20X7 financial statements were authorised for issue. Based on this alone, the company would not recognise a provision at 31 December 20X7 and the $10 million cost of the court case would be recognised in the 20X8 financial statements. If the company's lawyers had advised Europa that it was probable that they would be found guilty and suggested the expected settlement amount before the financial statements were authorised for issue, the provision would be recognised in the 20X7 financial statements reporting under IFRS Standards for that amount.

Answer to Interactive question 6

30% × £4m = £1.2m

The tax rate for the entire year is applied to the profits for the interim period.

Answer to Interactive question 7

(a) **Production machinery**

In this case the key issue is whether or not the asset should be classified as held for sale. In accordance with IFRS 5 a held-for-sale asset must be available for immediate sale. In this instance this does not appear to be the case, as the asset is still required for production purposes until after the year end. It should only be classified as held for sale at the end of January 20X8 when it has been serviced and uninstalled. Relevant audit evidence would include orders to be fulfilled compared to goods made by this machine compared to available inventory, budgets and inquiries of production staff.

Land

The key issue is the valuation of the land. As the entity has adopted the revaluation model the land should have been revalued to fair value (£210,000) immediately before being reclassified as held for sale. Any gain would be recognised in the revaluation surplus and disclosed as other comprehensive income in the statement of profit or loss and other comprehensive income. On reclassification the £6,000 costs to sell would be recognised in profit or loss as an impairment loss resulting in a carrying value of the asset of £204,000 (£210,000 – £6,000).

(b) **Production machinery**

Audit procedures would be as follows:

- Discuss with management intentions to run down production and the timescales involved.
- Review minutes of management/board meetings to confirm management's intentions.
- If material, agree with the management the reclassification of the asset as part of plant and machinery.
- Consider whether an impairment adjustment is required as the asset will no longer be used for its current purpose.

Land

Audit procedures would be as follows:

- Review the process of estimating the fair value of the land on 1 October and the necessary advertising costs.
- Discuss with management why the land was not revalued on classification as held for sale.

Answers to Self-test questions

1 AZ

AZ statement of profit or loss and other comprehensive income for the year ended 31 March 20X3

	$'000
Revenue	124,900
Cost of sales (W1)	(94,200)
Gross profit	30,700
Distribution costs (W1)	(9,060)
Administrative expenses (W1)	(17,535)
Other expenses (W1)	(121)
Finance income	1,200
Finance costs (18,250 × 7%)	(1,278)
Profit before tax	3,906
Income tax expense	(976)
PROFIT FOR THE YEAR	2,930
Other comprehensive income:	
Gain on land revaluation	4,000
Total comprehensive income for the year	6,930

AZ statement of financial position as at 31 March 20X3

	$'000
Non-current assets	
Property, plant and equipment (W2)	48,262
Investment properties	24,000
	72,262
Current assets	
Inventories (5,180 – (W3) 15)	5,165
Trade receivables	9,330
Cash and cash equivalents	1,190
	15,685
	87,947
Equity	
Share capital (20,000 + (W4) 2,000)	22,000
Share premium (430 + (W4) 400)	830
Retained earnings (28,077 – 1,000 + 2,930)	30,007
Revaluation surplus (3,125 + 4,000)	7,125
	59,962

	$'000
Non-current liabilities	
7% loan notes 20X7	18,250
Current liabilities	
Trade payables	8,120
Income tax payable	976
Interest payable (1,278 – 639)	639
	9,735
	87,947

AZ statement of changes in equity for the year ended 31 March 20X3

	Share capital	Share premium	Retained earnings	Revaluation surplus	Total
	$'000	$'000	$'000	$'000	$'000
Balance at 1 April 20X2	20,000	430	28,077	3,125	51,632
Issue of share capital	2,000	400			2,400
Dividends	(1,000)				(1,000)
Total comprehensive income for the year			2,930	4,000	6,930
Balance at 31 March 20X3	22,000	830	30,007	7,125	59,962

WORKINGS

(1) **Expenses**

	Cost of sales	Distribution	Admin	Other
	$'000	$'000	$'000	$'000
Per TB	94,000	9,060	16,020	121
Opening inventories	4,852			
Depreciation on buildings (W2)			1,515	
Depreciation on P&E (W2)	513			
Closing inventories (5,180 – (W3) 15)	(5,165)			
	94,200	9,060	17,535	121

(2) **Property, plant and equipment**

	Land	Buildings	P&E	Total
	$'000	$'000	$'000	$'000
Cost b/d	20,000	30,300	3,720	54,020
Acc'd depreciation b/d		(6,060)	(1,670)	(7,730)
	20,000	24,240	2,050	46,290

	Land	Buildings	P&E	Total
	$'000	$'000	$'000	$'000
Depreciation charge for year:				
$30,300 × 5%	–	(1,515)		(1,515)
($3,720 – $1,670) × 25%			(513)	(513)
	20,000	22,725	1,537	44,262
Revaluation (balancing figure)	4,000			4,000
Carrying amount c/d	24,000	22,725	1,537	48,262

CHAPTER 9

(3) **Inventories**

Defective batch:

	$'000
Selling price	55
Cost to complete: repackaging required	(20)
∴ NRV	35
Cost	(50)
∴ Write-off required	(15)

(3) **Share issue**

The proceeds have been recorded separately in the trial balance. This requires a transfer to the appropriate accounts:

		$'000	**$'000**
DEBIT	Proceeds of share issue	2,400	
CREDIT	Share capital (2,000 × $1)		2,000
CREDIT	Share premium (2,000 × $0.20)		400

2 Viscum

£11,000

IFRS 5.15 requires assets classified as held for sale to be measured at the time of classification at the lower of (1) the carrying value (£30,000) and (2) the fair value less costs to sell (£19,000).

IFRS 5.20 requires recognition of the resulting impairment loss (£30,000 – £19,000). The gain or loss on disposal is treated separately per IFRS 5.24.

3 Reavley

£19,500

IFRS 5.15 requires that a non-current asset held for sale should be stated at the lower of (1) the carrying amount (£19,500) and (2) the fair value less costs to sell (£24,550).

4 Smicek

£40,000

At the end of the current year, a non-current asset that has ceased to be classified as held for sale should be valued at the lower of:

(1) The carrying amount had it not been recognised as held for sale, ie, to charge a full year's depreciation of £100,000 for 20X7 and reduce the carrying amount from £900,000 at 31 December 20X6 to £800,000.

(2) The recoverable amount, which is the higher of the £790,000 fair value less costs to sell (£810,000 less £20,000) and value in use (the cash flows generated from using the asset) of £1,200,000.

Therefore the asset should be carried at £800,000 in the statement of financial position at 31 December 20X7.

At the end of the prior year, when the asset was classified as held for sale, the asset would have been carried at the lower of carrying amount (£900,000) and fair value less costs to sell of £840,000 (£860,000 less £20,000). Therefore the asset has fallen in value from £840,000 to £800,000 in the current year, giving a charge to profits of £40,000.

5 Ndombe

31 December 20X6: the assets should be shown in the statement of financial position at a value of £1,140,000.

31 December 20X7: the assets should be shown in the statement of financial position at a value of £1,040,000.

At the end of 20X6 the assets are classified as held for sale. The assets should be measured at the lower of carrying amount and fair value less costs to sell (IFRS 5.15). The carrying amount was £1,140,000 and the fair value less costs to sell was £1,180,000 so they were measured at £1,140,000. No depreciation is charged on these assets in 20X7 (IFRS 5.25).
At the end of 20X7, it is still possible to classify the 'other' assets as held for sale as the company is still committed to the sale (IFRS 5.29). These assets would be measured at fair value less costs to sell of £880,000, as this is lower than the carrying amount of £900,000.

However, the polishing machine should be valued at the lower of £160,000 carrying amount had classification as held for sale not occurred (£400,000 × 2/5) and the higher of fair value less costs to sell (£190,000) and value in use (£170,000) (IFRS 5.27). This gives a value of £160,000.

This gives a total value of £1,040,000 at 31 December 20X7.

6 Sapajou

An expense of £20,000 is shown in the profit or loss part of the statement of profit or loss and other comprehensive income for the year ended 31 December 20X6.

Income of £20,000 is shown in the profit or loss part of the statement of profit or loss and other comprehensive income for the year ended 31 December 20X7.

Under IFRS 5.15 an asset classified as held for sale is measured at the lower of carrying amount immediately before the reclassification of £900,000 (£1,200,000 – 2.5 × £120,000), and fair value less costs to sell of £880,000. The £20,000 impairment loss is charged to profits (IFRS 5.20).

In the following year, the increase in fair value less costs to sell is £115,000, but only £20,000 of this can be recognised in profit (IFRS 5.21) as this is the reversal of the previous impairment loss.

7 Sulafat

Disclosure is required of transactions with both Vurta and Piton. See IAS 24.3, which states that entities under both direct and common control are related parties.

8 Phlegra

Nil under IAS 24.11 (a) two entities are not related parties simply because they have a director in common, nor per IAS 24.11 (b) simply because the volume of transactions between them results in economic dependence.

So neither Nereidum nor Chub is a related party of Phlegra.

9 Mareotis

£300,000

Under IAS 24.9, Hayles is a related party of Mareotis. Bourne 'controls' Wrasse (by virtue of the power to appoint the majority of directors) and Wrasse 'controls' Hayles (by virtue of holding the majority of the equity). So Bourne 'controls' both Mareotis and Hayles, which are therefore related parties as a result of being under common control.

Being an aunt does not make Danielle a close member of Agnes's family so, although Galaxius is controlled by a relative of Agnes, the relationship is not close enough to make Galaxius a related party of Mareotis. So only transactions with Hayles have to be disclosed.

10 Marmoset

Nil

Interim reports should apply the normal recognition and measurement criteria, using appropriate estimates under IAS 34.41.

There is no legal or constructive obligation at the interim reporting date to pay the bonus, as no announcement had been made at this date. Under IAS 34 App B B6 no expense is required.

11 Aconcagua

Inventory values change

Six months ending 30 June 20X7	£20,000 profit decrease
Six months ending 31 December 20X7	£16,000 profit increase

Interim reports should apply the normal recognition and measurement criteria, using appropriate estimates under IAS 34.41. IAS 34 App B B25–B26 links these general principles to inventories by requiring them to be written down to net realisable value at the interim date; the write down is then reversed at the year end, if appropriate.

So the profit decrease in the six months to 30 June 20X7 is 2,000 × (£30 – £20) = £20,000, while the profit increase in the six months to 31 December 20X7 is 2,000 × (£28 – £20) = £16,000.

Chapter 10

Reporting revenue

Introduction

Learning outcomes

- Identify and explain current and emerging issues in corporate reporting
- Explain how different methods of recognising and measuring assets and liabilities can affect reported financial performance
- Explain and appraise accounting standards that relate to reporting performance: in respect of financial statements; revenue; operating segments; continuing and discontinued operations; EPS; interim reporting
- Calculate and disclose, from financial and other qualitative data, the amounts to be included in an entity's financial statements according to legal requirements, applicable financial reporting standards and accounting and reporting policies
- Determine for a particular scenario what comprises sufficient, appropriate audit evidence
- Design and determine audit procedures in a range of circumstances and scenarios, for example identifying an appropriate mix of tests of controls, analytical procedures and tests of details
- Demonstrate and explain, in the application of audit procedures, how relevant ISAs affect audit risk and the evaluation of audit evidence

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
1	**Context** Revenue is often the single largest item in the financial statements, and has in the past been open to manipulation. This led to the development of a recent standard IFRS 15, *Revenue from Contracts with Customers.* IFRS 15 recognises separate performance obligations will arise	**Approach** You have met this topic before, but now it is examinable at Level A. Read through this introductory section quickly. **Stop and think** Can you think of any recent scandals involving recognition of revenue?	This section deals with background knowledge only.	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
	for distinct goods or services. This could result in some revenue being attributed to goods or services that were previously considered incidental to the contract – for instance, to mobile phones that are provided free of charge with airtime contracts and to some post-delivery services, such as maintenance and installation.			
2	**IFRS 15, *Revenue from Contracts with Customers*** The five-stage model will be used in practice for recognising revenue and is useful for exam questions.	**Approach** Pay particular attention to the five-stage model for recognising revenue in section 2: (1) Identify the contract(s) with a customer. (2) Identify separate performance obligations. (3) Determine the transaction price. (4) Allocate transaction price to performance obligations. (5) Recognise revenue as or when each performance obligation is satisfied. **Stop and think** A performance obligation can be satisfied at a point in	IFRS 15 is a recent, topical standard, and could be tested in a number of ways. It was examined for the first time in July 2019, when it formed a large part of the content of Question 3 (audit and financial reporting). The five-stage model will help structure your answer in an exam, but you will get no marks for just listing them without applying them to a scenario.	**IQ1–4** Work through all the examples and questions on applying this model, especially: **IQ5: Caravan** This deals with all five stages of IFRS 15.

CHAPTER 10

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
		time, such as in retail sales, or over time, such as a construction contract taking place over weeks, months or even years. You will not have studied construction contracts before, so pay particular attention to section 2.10.		
3	**Applications of IFRS 15** Section 3 deals with specific applications of IFRS 15. The most important of these are sale or return, sale and repurchase and goods and services in the same contract.	**Approach** You will have dealt with these topics at Professional Level, so read through for revision and focus on doing the interactive questions. **Stop and think** In a principal/agent relationship, what is the agent's revenue?	Any of these topics could come up in an exam. Revenue is regularly examined and could take up most of the question.	Work through all the examples and questions on applying this model, especially: **IQ6: Sale or return** This is not as straightforward as you might think.
4	**Audit focus** This gives auditing guidance relating to each stage of IFRS 15 and for specific transactions.	**Approach** Study this section carefully and attempt the integrated interactive question. **Stop and think** Where performance obligations are satisfied over time, how would you determine whether contract costs had been overstated?	To avoid repetition of the five stages, it is best to deal with each stage first from the FR point of view, then in terms of auditing. Questions are very likely to test both.	**IQ11: Construction contracts** A must-do question on auditing revenue from contracts in which performance obligations are satisfied over time.

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Context

Section overview

- Income, as defined by the IFRS Foundation's *Conceptual Framework*, includes both revenues and gains. Revenue is income arising in the ordinary course of an entity's activities and it may be called different names, such as sales, fees, interest, dividends or royalties.
- IFRS 15, *Revenue from Contracts with Customers* establishes a single comprehensive framework for accounting for the majority of contracts that result in revenue.
- Revenue recognition is straightforward in most business transactions, but can be complicated in some situations.

1.1 Accrual accounting

Financial statements are prepared on the underlying assumption of the **accrual basis** of accounting, whereby effects of transactions are recognised **when they occur** and not when the cash associated with them is received or paid.

But this raises questions about **when** a transaction 'occurs':

- Is it when the buyer takes possession of the goods, in circumstances where the contract for sale contains clauses that seek to ensure that ownership does not pass to the customer until the seller has been paid in full?
- Is it when services are provided, in circumstances where the seller undertakes to come back to do additional work without charge if needed, e.g., remedial work carried out by a building contractor?
- When does the profit arise on a contract for the provision of services to a customer over time, such as under a maintenance contract of two years' duration? Only at the start, only in the middle, only at the end, or over the period of two years?

IFRS 15, *Revenue from Contracts with Customers* was brought in to address this.

Professional skills focus: Assimilating and using information

It is by no means always easy in practice to assimilate information about revenue, as the points above show. An exam question is likely to contain a detailed scenario with revenue apparently occurring at different times.

1.2 Significance of revenue

Revenue is often the largest single item in the financial statements. US studies have shown that over half of all financial statement frauds and requirements for restatements of previously published financial information involved revenue manipulation.

1.2.1 Significance for your exam

IFRS 15 has been tested in a number of ways. It was examined for the first time in July 2019, when it formed a large part of the content of Question 3 (audit and financial reporting). The question focused mainly on performance obligations satisfied (or not satisfied) over time, and was set in the context of financial reporting (comment on recognition policy), risk of misstatement and a potential ethical issue (breach of contract). Reference was also made to data analytics, which continues to be a focus of future questions on revenue.

In Question 2 of November 2019 the focus was on correct allocation of the transaction price to performance obligations for a loyalty points scheme (when the points are redeemed or expire) and an audio and music streaming service (based on standalone price). This was in the context of adjusting draft financial statements and re-calculating ratios.

Question 3 in November 2020 focused on the timing of revenue recognition in the context of club membership, ie, when the performance obligation is satisfied rather than when the membership fee is received or an event booked. The question also covered auditing aspects of revenue and analytical review procedures.

In July 2021, IFRS 15 was examined in Question 1, where the use of data analytics software was needed in order to identify anomalies in timing of revenue recognition. By using the software candidates would have been able to identify a significant transaction posted out of hours. This gave rise to an audit risk of revenue overstatement.

IFRS 15 has therefore been examined in all three questions in the Corporate Reporting exam.

2 IFRS 15, *Revenue from Contracts with Customers*

Section overview

- Revenue is income arising in the course of an entity's ordinary activities.
- Revenue should be recognised to depict the transfer of goods or services to a customer in an amount that reflects the consideration to which the entity expects to be entitled.
- Generally revenue is recognised when the entity has transferred to the buyer control of the asset.
- IFRS 15 sets out a five-stage process for this.

Tutorial Note

This material should be familiar to you from your studies at Professional Level. So we would advise skim-reading the explanations and going straight to the examples or questions, coming back to the detail if you get stuck.

2.1 Objective and scope

The objective of IFRS 15 is to establish the principles that should be applied to report on the nature, amount, timing and uncertainty of revenue and cash flows arising from a contract with a customer.

(IFRS 15.1)

IFRS 15 applies to all contracts with customers except:

- leases within the scope of IFRS 16, *Leases*
- insurance contracts within the scope of IFRS 4, *Insurance Contracts*
- non-monetary exchanges between entities in the same line of business

2.2 Revenue

Income is defined in the IASB's *Conceptual Framework* (para. 4.2) as "Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims." **Revenue is simply income arising in the course of an entity's ordinary activities** (IFRS 15: Appendix A) and it may be called different names such as:

- Sales
- Turnover
- Interest
- Dividends
- Royalties

2.3 Core principle

The core principle of IFRS 15, *Revenue from Contracts with Customers* is that an entity recognises revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services (IFRS 15. IN7).

The transfer of goods and services is evidenced by the transfer of **control**.

Revenue is recognised in accordance with this core principle by applying a five-step model.

2.4 Five-step model

IFRS 15 takes a five-step approach to recognising revenue:

Step 1 Identify the contract(s) with a customer.

Step 2 Identify separate performance obligations.

Step 3 Determine the transaction price.

Step 4 Allocate transaction price to performance obligations.

Step 5 Recognise revenue as or when each performance obligation is satisfied.

Revenue is therefore recognised when control over goods or services is transferred to the customer.

Professional skills focus: Structuring problems and solutions

IFRS 15 is a good example of an IFRS structuring a problem. The five-stage process provides the structure.

2.5 Identify the contract with the customer

The contract can be written, verbal or implied. For instance, in retail sales the contract is implied. The criteria to be met are as follows:

(a) All parties have approved the contract.

(b) The entity can identify each party's rights regarding the goods or services to be transferred.

(c) The payment terms can be identified.

(d) The contract has commercial substance.

(e) It is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services.

(IFRS 15.9)

2.6 Identify the performance obligations in the contract

A performance obligation is a promise to transfer to the customer either:

(a) a **distinct** good or service (or bundle of goods or services); or

(b) a series of **distinct** goods or services.

(IFRS 15.22)

A good or service is **distinct** if it can be sold separately and has a distinct function. If this does not apply, it will form part of a distinct bundle.

The definition of **distinct** is therefore key when identifying separate performance obligations. **A good or service** (or a bundle of goods or services) is distinct if the customer can benefit from the good or service on its own or together with other readily available resources and the entity's promise is separately identifiable from other promises in the contract).

If goods or services are not distinct, the reporting company must combine them with other promised goods or services until a bundle of goods or services that is distinct can be identified.

Worked example: Performance obligations (1)

Colossal Construction plc has recently signed a contract to build a warehouse for SupaSave Ltd. Colossal Construction is responsible for designing the building, preparing the site, purchasing raw materials, construction, plumbing, wiring and finishing.

Requirement

Identify the performance obligation(s) in the contract.

Solution

In the context of this contract, Colossal Construction is contracted to provide a significant service of integrating the inputs in order to produce a single output; this being the warehouse. Therefore, the provision of each good or service is not separately identifiable.

The promises are not distinct and therefore there is only a single performance obligation, being the development of the property.

Worked example: Performance obligations (2)

MetaConnect Software Services plc (MetaConnect) supplies computer aided design packages to customers. It has recently signed a contract with EverTel Design Ltd to provide a licence to use a software package, installation service (which does not involve customising the software package) and technical support for four years. MetaConnect is not the only company that could install the software and provide technical support.

Requirement

Identify the performance obligation(s) in the contract.

Solution

Each good or service provided (the provision of the licence, the installation service and the technical support) is capable of being distinct because a customer could gain benefit from each either on its own or by obtaining the other goods/services from another supplier. The good or service could therefore benefit the customer either on its own or together with other resources that are readily available.

In the context of this contract, MetaConnect is not integrating the goods or services, none of the goods or services modifies another and the goods/services are not highly interrelated. Therefore each promise is separately identifiable. Therefore the promise to transfer the good or service to the customer is separately identifiable from other promises in the contract

In conclusion, there are three distinct performance obligations in the contract, being:

(1) Installation of the software

(2) Provision of the licence

(3) Provision of technical support

2.7 Determine the transaction price

This is the amount of consideration in a contract to which an entity expects to be entitled for transferring promised goods or services to a customer (IFRS 15.47).

This may include both fixed and variable elements but not amounts collected on behalf of third parties. Variable amounts could be discounts, refunds, price concessions, incentives, bonuses or other items.

Variable consideration is included in the transaction price based on either:

- its expected value (the sum of probability weighted amounts in a range of possible outcomes); or
- the single most likely amount (the single most likely amount in a range of possible consideration amounts).

The expected value approach is generally appropriate if the vendor has a large number of contracts with similar characteristics.

The single most likely outcome may be appropriate if a contract has only two possible outcomes (eg, an entity achieves a performance bonus or does not).

The chosen approach should be that which is expected to provide a better prediction of consideration.

Variable consideration is included in the transaction price only to the extent that it is highly probable that a significant amount will not be reversed when the uncertainty associated with the variable consideration is resolved. When assessing whether it is highly probable that a significant reversal will not occur once the uncertainty related to the variable consideration is subsequently resolved, an entity should consider both the likelihood and magnitude of the revenue reversal. Factors that may increase the likelihood or magnitude of reversal include **any** of the following:

(a) The amount of consideration is very susceptible to factors outside the entity's influence eg, weather conditions or market volatility.

(b) The uncertainty about consideration is not expected to be resolved for a long period of time.

(c) The entity's experience with similar types of contracts is limited or has limited predictive value.

(d) The entity has a practice of offering a wide range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.

(e) The contract has a large number and broad range of possible consideration amounts.

Worked example: Variable consideration

On 1 July 20X8, Danmar Construction plc (Danmar) signs a contract to build an extension to a retail outlet. The total price agreed is £80 million. The contract terms require completion by 31 March 20X9. The price will decrease by £200,000 for every day after this date that the project remains incomplete. At the year end of 31 December 20X8, Danmar expects that there is an 80% chance of the project being completed on time, a 10% chance of it being completed a day late, a 7% chance of it being completed two days late and a 3% chance of it being completed three days late.

Requirement

What is the transaction price?

Solution

The consideration is variable due to the fact that Danmar will accept an amount that is less than the price stated in the contract if the project overruns (the price concession).

Here the calculation of transaction price is based on expected values.

	£
80% × £80,000,000	64,000,000
10% × £79,800,000	7,980,000
7% × £79,600,000	5,572,000
3% × £79,400,000	2,382,000
Transaction price	79,934,000

2.8 Allocate the transaction price to the performance obligations in the contract

The transaction price is allocated to each performance obligation on the basis of the stand-alone selling price of each distinct good or service in the contract. If the good or service does not have a stand-alone selling price, it will need to be estimated (IFRS 15.IN7).

This applies particularly where a bundle of goods is sold which the entity also supplies unbundled. An example of this is a mobile phone service contract which includes a free handset. In accordance with IFRS 15, the entity will have to allocate some of the revenue to the handset, based on its stand- alone selling price.

Worked example: Allocation of transaction price

The contract between MetaConnect and EverTel Design (see Worked example: Performance obligations 2) is priced at £6,000. The stand-alone selling prices of each element are as follows:

	£
Provision of a licence	5,000
Installation service	1,500
	£
Provision of technical support	3,000
	9,500

Requirement

Allocate the transaction price to the performance obligations in the contract.

Solution

Licence provision £5,000/£9,500 × £6,000 = £3,158 Installation service £1,500/£9,500 × £6,000 = £947 Technical support service £3,000/£9,500 × £6,000 = £1,895

Context example: Unbundling

A mobile phone company gives customers a free handset when they sign a two-year contract for provision of network services. The handset has a stand-alone price of £52 and the contract is for £20 per month.

Under IFRS 15, revenue must be allocated to the handset because delivery of the handset constitutes a performance obligation. This will be calculated as follows:

	£	%
Handset	52	10
Network services	480	90
Total value	532	100

As the transaction price is the total receipts of £480, this is the amount which must be allocated to the separate performance obligations.

Revenue will be recognised as follows:

	£
Year 1	
Handset (480 × 10%)	48
Contract (480 – 48)/2	216
	264
Year 2	
Contract as above	216

2.9 Recognise revenue when (or as) a performance obligation is satisfied

A performance obligation is satisfied when control of the good or service specified in the contract is transferred to the customer (IFRS 15.31).

A performance obligation can be satisfied **at a point in time**, such as in retail sales, or **over time**, such as a construction contract taking place over weeks, months or even years.

Where a performance obligation is satisfied **at a point in time**, that point will occur when **control is transferred**. At that point the customer is able to direct the use of the asset and obtain substantially all the remaining benefits from it (IFRS 15.33).

The following events can indicate that control has been transferred (IFRS 15.38):

- The entity has a present right to payment for the asset
- The customer has legal title to the asset
- The entity has transferred physical possession of the asset

- The significant risks and rewards of ownership have been transferred to the customer
- The customer has accepted the asset

A performance obligation satisfied **over time** will meet one of the following criteria:

- The customer simultaneously receives and consumes the benefits as the performance obligation is satisfied.
- The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.
- The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

(IFRS 15.35)

Where performance obligations are satisfied over time, the entity recognises revenue by measuring progress towards complete satisfaction of the performance obligation. Progress can be measured using output methods (measuring the value to the customer of goods or services transferred to date) or input methods (measuring the cost to the entity of goods or services transferred to date) (IFRS 15.B14).

In the early stages of a contract it may not be possible to reasonably measure the outcome of a performance obligation, but the entity is entitled to recover costs incurred. In this case, revenue can be measured to the extent of costs incurred.

A contract where performance obligations are recognised over time may give rise to asset or liability amounts at the end of the reporting period.

Contracts with customers will be presented in an entity's statement of financial position as a contract liability, a contract asset or a receivable, depending on the relationship between the entity's performance and the customer's payment.

(IFRS 15.105)

A **contract liability** is recognised and presented in the statement of financial position where a customer has paid an amount of consideration prior to the entity performing by transferring control of the related good or service to the customer.

(IFRS 15.106)

When the entity has performed but the customer has not yet paid the related consideration, this will give rise to either a **contract asset** or a **receivable**. A contract asset is recognised when the entity's right to consideration is conditional on something other than the passage of time, for instance future performance. A receivable is recognised when the entity's right to consideration is unconditional except for the passage of time.

(IFRS 15.107)

Where revenue has been invoiced a receivable is recognised. Where revenue has been earned but not invoiced, it is recognised as a contract asset.

Worked example: Performance obligation satisfied over time

Associated Solutions Ltd is building a bespoke software system for an insurance company. The contract started on 1 January 20X7 with an estimated completion date of 31 December 20X9. The contract price is £2 million. As at 31 December 20X7:

(1) costs incurred amounted to £800,000;

(2) half the work on the contract was completed;

(3) certificates of work completed have been issued by the insurance company, to the value of £1 million; and

(4) it is estimated with reasonable certainty that further costs to completion will be £800,000.

Requirement

What is the contract profit in 20X7, and what entries would be made for the contract at 31 December 20X7?

Solution

This is a contract in which the performance obligation is satisfied **over time**. The entity is carrying out the work for the benefit of the customer rather than creating an asset for its own use and in this case it has an enforceable right to payment for work completed to date. We can see this from the fact that certificates of work completed have been issued.

IFRS 15 states that the amount of payment that the entity is entitled to corresponds to the amount of performance completed to date (ie, goods and/or services transferred).

In this case, the contract is certified as 50% complete, measuring progress under the output method. At 31 December 20X7, the entity will recognise revenue of £1,000,000 and cost of sales of £800,000, leaving profit of £200,000. The **contract asset** will be the costs to date plus the profit – that is £1,000,000. We are not told that any of this amount has yet been invoiced, so none of this amount is classified as receivables.

Interactive question 1: Publishing revenue

A magazine publisher launched a new monthly magazine on 1 January 20X7. During January it received £48,000 in annual subscriptions in advance. It has despatched four issues by the year end 31 March 20X7.

Requirement

What revenue should be recognised for the year ended 31 March 20X7?

See **Answer** at the end of this chapter.

Interactive question 2: Advance sales

A DIY store is about to sell a new type of drill. Customer demand is high and the store has taken advance orders for the drill. The selling price of the drill will be £50 and so far 200 customers have paid an initial 10% deposit on the selling price of the drill. No drills are yet held in inventory.

Requirement

What amount should be recognised as revenue? See **Answer** at the end of this chapter.

Interactive question 3: Rendering of services

A £210,000 fixed-price contract is entered into for the provision of services. At the end of 20X7, the first accounting period, the contract is thought to be 33% complete and costs of £45,000 have been incurred in performing that 33% of the work.

Requirements

Calculate the revenue to be recognised in 20X7 on the alternative assumptions that:

(a) The costs to complete are reliably estimated at £90,000; and

(b) The costs to complete cannot be reliably estimated, and it is thought that £40,000 of the costs incurred are recoverable from the customer.

See **Answer** at the end of this chapter.

Interactive question 4: Service contract

An entity entered into a contract for the provision of services over a two year period. The total contract price was £150,000 and the entity initially expected to earn a profit of £20,000 on the contract. In the first year, costs of £60,000 were incurred and 50% of the work was completed. The contract did not progress as expected and management was not sure of the ultimate outcome but believed that the costs incurred to date would be recovered from the customer.

Requirement

What revenue should be recognised for the first year of the contract? See **Answer** at the end of this chapter.

2.10 Performance obligations satisfied over time: 'construction contracts'

IFRS 15 does not specifically use the term 'construction contracts', but refers to them as contracts in which performance obligations are satisfied over time. Such contracts often include contracts for large construction projects falling into more than one accounting period. As mentioned in section

2.9 above, the entity recognises revenue by measuring progress towards complete satisfaction of the performance obligation. Progress can be measured using output methods (measuring the value to the customer of goods or services transferred to date) or input methods (measuring the cost to the entity of goods or services transferred to date) (IFRS 15.B14).

Worked example: Contract to construct a conference centre

During the year ended 31 July 20X9, Frizco Construction plc (Frizco) began the construction of a leisure centre on behalf of a local authority. The agreed contract price was £70 million. However this will be reduced by £6 million if Frizco completes the centre a month or more behind schedule.

During the year ended 31 July 20X9, costs incurred amounted to £18.6 million, including £1,000,000 material that could not be used in the project as it was of the incorrect grade to meet regulations.

The total cost of the project (excluding the £1,000,000 in wasted material) is estimated to be £44 million. Work certified at the year-end was £24.5 million.

The construction is currently progressing in accordance with the agreed schedule.

Requirements

1 What amount of revenue is recognised in profit or loss in the year ended 31 July 20X9 if an output method is used to assess progress?

2 What amount of revenue is recognised in profit or loss in the year ended 31 July 20X9 if an input method is used to assess progress?

Solution

The transaction price is £70 million. £64 million is fixed consideration and £6 million is variable consideration. The transaction price is £70 million as the project is currently expected to be completed on time and therefore the single most likely outcome is the receipt of £70 million.

1 **Output method**

Using the output method the project is 35% complete:

Work certified ÷ Transaction price = 24,500 ÷ 70,000 = 35%

Therefore 35% × £70m = £24.5 million is recognised as revenue in the year.

2 **Input method**

Using the input method the project is 40% complete:

Costs incurred to date ÷ Total expected costs = (18,600 – 1,000) ÷ 44,000 = 40% Therefore 40% × £70m = £28 million is recognised as revenue in the year.
Note that the £1 million wasted material is not relevant to the assessment of progress, however, it must be recognised in profit or loss as a wastage expense.

Contract costs are considered in further detail in section 2.12.

2.11 Deferred consideration

In some sectors of the retail industry it is common practice to provide interest-free credit to customers in order to encourage sales of, for example, furniture and new cars.

IFRS 15 refers to this as a 'financing component' in the contract. When the contract contains a significant financing component, such as a period of interest-free credit exceeding one year, the amount of consideration should be adjusted for the time value of money (IFRS 15.60, .63).

Where an extended period of credit is offered, the revenue receivable has two separate elements:

- The value of the goods on the date of sale
- Financing income

In order to separate these two elements the future receipts are discounted to present value at an imputed interest rate, identified as either:

- the prevailing rate for lending to a customer with a credit rating similar to that of the customer; or
- the rate of interest which discounts the receivable back to the current cash selling price.

The effect on the timing of the revenue recognition is that:

- the fair value of the goods is recognised on delivery of the goods
- the finance element is recognised over the period that the financing is provided

Worked example: Deferred consideration 1

A car retailer sells its new cars by requiring a 20% deposit followed by no further payments until the full balance is due after two years. The price of the cars is calculated using a 10% per annum finance charge.

On 1 January 20X7 a car was sold to a customer for £20,000.

Requirement

How should the revenue be recognised in the year ended 31 December 20X7 and what should the carrying amount of the customer receivable be on that date?

Solution

Revenue to be recognized

	£
Sale of goods (£4,000 + £13,223 (W))	17,223
Financing income (£13,223 (W) × 10%)	1,322
Carrying amount of receivable (£13,223 (W) × 1.10)	14,545

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The deposit is £4,000 (£20,000 × 20%), so the amount receivable in two years is £16,000. This is discounted at 10% for two years to £13,223 (£16,000 × $1/1.10^2$).

Context example: Deferred consideration 2

Comfy Couches Ltd sells an item of furniture to a customer on 1 September 20X7 for £2,500 with a one-year interest-free credit period. The fair value of the consideration receivable is £2,294. (In other words, if the company tried to sell this debt, this is the amount it would expect to receive now.)

In this case the transaction would be split into two components:

(a) Interest revenue of £206 (2,500 – 2,294), which would be recognised over the period of credit

(b) Sales revenue of £2,294, which would be recognised on 1 September 20X7

2.12 Contract costs

IFRS 15 deals with the costs of obtaining a contract and the costs of fulfilling a contract.

2.12.1 Costs of obtaining a contract

The incremental costs of **obtaining** a contract (such as sales commission) are **recognised as an asset** if the entity expects to recover those costs.

Costs that would have been incurred regardless of whether the contract was obtained are recognised as an expense as incurred.

Costs incurred in **fulfilling** a contract, unless within the scope of another standard, (such as IAS 2, *Inventories*, IAS 16, *Property, Plant and Equipment* or IAS 38, *Intangible Assets*) are recognised as an asset if they meet the following criteria (IFRS 15.95):

(a) The costs relate directly to an identifiable contract (costs such as labour, materials, management costs)

(b) The costs generate or enhance resources of the entity that will be used in satisfying (or continuing to satisfy) performance obligations in the future

(c) The costs are expected to be recovered

Costs recognised as assets are amortised on a systematic basis consistent with the transfer to the customer of the goods or services to which the asset relates.

Worked example: Costs of obtaining a contract

Copyquick Ltd enters into contracts for five-year terms to service and repair a customer's photocopiers. The contracts may be subsequently renewed on a one-year rolling basis and the average customer term is seven years. Copyquick pays its sales staff a commission of £35,000 when a new customer signs an initial contract.

On 1 January 20X8, the Copyquick sales staff secured a new customer contract.

Requirement

How is the cost of commission of £35,000 accounted for?

Solution

The £35,000 is an incremental cost of obtaining a new contract, and Copyquick expects to recover the cost by charging the customer for servicing and repairing their photocopiers.

Copyquick should capitalise the £35,000 and amortise it over a period to reflect the transfer of services to the customer. Although the original contract is for five years, this is usually extended for a further two years and so the amortisation period is seven years.

Therefore the annual amortisation charge is £5,000 (£35,000/7 years).

Professional skills focus: Applying judgement

As we have seen, while IFRS 15 provides structure and guidance, it does not remove the need for judgement. The area of costs is one where judgement must be applied. An example of this is the question of whether to use an input method or an output method.

2.13 Presentation and disclosure

2.13.1 Presentation

Contracts with customers will be presented in an entity's statement of financial position as a contract liability, a contract asset, or a receivable depending on the relationship between the entity's performance and the customer's payment.

A contract liability is recognised and presented in the statement of financial position where a customer has paid an amount of consideration before the entity has transferred control of the related good or service to the customer.

When the entity has performed but the customer has not yet paid the related consideration, this will give rise to either a contract asset or a receivable. A contract asset is recognised when the entity's right to consideration is conditional on something other than the passage of time, for instance future performance. A receivable is recognised when the entity's right to consideration is unconditional except for the passage of time.

Where revenue has been invoiced, a receivable is recognised. Where revenue has been earned but not invoiced, it is recognised as a contract asset.

2.13.2 Disclosure

Disclosure of the following is required:

(a) Revenue from contracts with customers (separately from other sources of revenue) in categories that depict how the nature, timing, amount and uncertainty of revenue and cash flows are affected by economic factors (eg, by type of goods or geographical area). Sufficient information should be disclosed to enable users to understand the relationship between the disclosure of disaggregated revenue and revenue information that is disclosed for each reportable segment (where IFRS 8 is applied).

(b) Impairment losses recognised on receivables, or contract assets arising from contracts with customers (by category, as above).

(c) The opening and closing balances of receivables, contract assets and contract liabilities and explanation of significant changes in contract assets and liabilities, including both qualitative and quantitative information.

(d) Revenue recognised in the reporting period that was included in the contract liability balance at the start of the period and revenue recognised in the period from performance obligations satisfied in previous periods (eg, due to changes in transaction price).

(e) A description of performance obligations including the following:
   (1) When they are typically satisfied
   (2) Significant payment terms
   (3) The nature of goods or services that an entity has promised to transfer, highlighting obligations to arrange for another party to transfer goods or services
   (4) Obligations for returns, refunds or similar
   (5) Types of warranties and related obligations

(f) The transaction price allocated to performance obligations that are unsatisfied at the end of the reporting period, and an explanation of when related revenue is expected to be recognised. This information need not be disclosed if the performance obligation is part of a contract lasting 12 months or less, or the entity recognises revenue from the satisfaction of the performance obligation in the amount that it has a right to invoice (because the amount directly corresponds with the value to the customer of the entity's performance completed to date).

Worked example: Applying the IFRS 15 five-step model

On 1 January 20X4, Peterloo enters into a 12-month 'pay monthly' contract for a mobile phone. The contract is with Westerfield, and terms of the plan are as follows:

- Peterloo receives a free handset on 1 January 20X4.
- Peterloo pays a monthly fee of £200, which includes unlimited free minutes. Peterloo is billed on the last day of the month.

Customers may purchase the same handset from Westerfield for £500 without the payment plan. They may also enter into the payment plan without the handset, in which case the plan costs them £175 per month.

The company's year-end is 31 July 20X4.

Requirement

Show how Westerfield should recognise revenue from this plan in accordance with IFRS 15, *Revenue from Contracts with Customers.* Your answer should give journal entries:

(1) On 1 January 20X4

(2) On 31 January 20X4

Solution

IFRS 15 requires application of its five-step process:

(1) **Identify the contract with a customer.** A contract can be written, oral or implied by customary business practices.

(2) **Identify the separate performance obligations in the contract.** If a promised good or service is not distinct, it can be combined with others.

(3) **Determine the transaction price.** This is the amount to which the entity expects to be **'entitled'**. For variable consideration, the probability-weighted expected amount is used.

(4) **Allocate the transaction price to the separate performance obligations in the contract.** For multiple deliverables, the transaction price is allocated to each separate performance obligation in proportion to the **stand-alone selling price** at contract inception of each performance obligation.

(5) **Recognise revenue when (or as) the entity satisfies a performance obligation.** That is when the entity **transfers** a promised good or service to a customer. The good or service is only considered as transferred when the customer obtains **control** of it.

Application of the five-step process to Westerfield

(1) **Identify the contract with a customer.** This is clear. Westerfield has a 12-month contract with Peterloo.

(2) **Identify the separate performance obligations in the contract.** In this case there are two distinct performance obligations:

   (a) The obligation to deliver a handset

   (b) The obligation to provide network services for 12 months

   (The obligation to deliver a handset would not be a distinct performance obligation if the handset could not be sold separately, but it is in this case because the handsets are sold separately.)

(3) **Determine the transaction price.** This is straightforward: it is £2,400, that is 12 months × the monthly fee of £200.

(4) **Allocate the transaction price to the separate performance obligations in the contract.** The transaction price is allocated to each separate performance obligation in proportion to the **stand-alone selling price** at contract inception of each performance obligation, that is the stand-alone price of the handset (£500) and the stand-alone price of the network services (£175 × 12 =£2,100):

Performance obligation	Stand-alone selling price £	% of total	Revenue (= relative selling price = £2,400 × %) £
Handset	500.00	19.2	460.80
Network services	2,100.00	80.8	1,939.20
Total	2,600.00	100	2,400.00

(5) **Recognise revenue when (or as) the entity satisfies a performance obligation.** That is when the entity transfers a promised good or service to a customer. This applies to each of the performance obligations:

- When Westerfield gives a handset to Peterloo, it needs to recognise the revenue of £460.80.
- When Westerfield provides network services to Peterloo, it needs to recognise the total revenue of £1,939.20. It's practical to do it once per month as the billing happens.

Journal entries

(1) On 1 January 20X4

The entries in the books of Westerfield will be:

DEBIT	Receivable (unbilled revenue)	£460.80	
CREDIT	Revenue		£460.80

Being recognition of revenue from the sale of the handset

(2) On 31 January 20X4

The monthly payment from Peterloo is split between amounts owing for network services and amounts owing for the handset:

DEBIT	Bank/Receivable (Peterloo)	£200	
CREDIT	Revenue (1,939.20/12)		£161.60
CREDIT	Receivable (unbilled revenue) (460.80/12)		£38.40

Being recognition of revenue from monthly provision of network services and 'repayment' of handset.

CHAPTER 10

Interactive question 5: Caravan

Caravans Deluxe is a retailer of caravans, dormer vans and mobile homes, with a year end of 30 June. It is having trouble selling one model – the £30,000 Mini-Lux, and so is offering incentives for customers who buy this model before 31 May 20X7.

(1) Customers buying this model before 31 May 20X7 will receive a period of interest free credit, provided they pay a non-refundable deposit of £3,000, an instalment of £15,000 on 1 August 20X7 and the balance of £12,000 on 1 August 20X9.

(2) Equipment for the caravan, normally worth £1,500, is included free in the price of the caravan.

On 1 May 20X7, a customer agrees to buy a Mini-Lux caravan, paying the deposit of £3,000. Delivery is arranged for 1 August 20X7.

As the sale has now been made, the sales director of Caravans Deluxe wishes to recognise the full sale price of the caravan, £30,000, in the accounts for the year ended 30 June 20X7.

Requirement

Show how the IFRS 15 five-step plan is applied to this sale. Assume a 10% discount rate. Show the journal entries for this treatment.

See **Answer** at the end of this chapter.

3 Applications of IFRS 15

Section overview

- IFRS 15 includes Application Guidance, which explains how the provisions of the standard should be applied to a number of situations.
- These include:
  - Sales with a right of return
  - Extended warranties
  - Transactions involving an agent
  - Licensing
  - Royalties
  - Repurchase agreements
  - Consignment arrangements
  - Bill and hold arrangements
  - Non-refundable upfront fees

3.1 Sales with a right of return

Some contracts give the customer the right to return the product and receive a refund, a credit or a replacement.

The entity should recognise (IFRS 15.B21):

- revenue for the transferred products
- a refund liability
- an asset in respect of products to be returned

The asset is:

- measured at the former carrying amount of the products less any expected decreases in value and other costs to recover the products;
- presented separately from the refund liability; and
- remeasured to reflect changes in expectations about the products to be returned at each reporting date.

Interactive question 6: Sale or return

Bags Galore Ltd operates a number of high-end handbag outlets. On 28 January 20X9, it sells 50 identical bags to different customers for £850 each. The bags cost £400 each. The customers have 28 days in which they can return purchases in exchange for a full refund and, based on past experience, Bags Galore Ltd expects a returns level of 6%. Bags Galore Ltd's 'Fabulous February' sale starts on 1 February and the selling price of the bags will be reduced to 50% of the original price from that date.

Requirements

6.1 How should Bags Galore account for the sale of the bags?

6.2 How would the accounting treatment change if the selling price of the bags was to be reduced to 40% of the original price in the Fabulous February sale?

See **Answer** at the end of this chapter.

3.2 Warranties

It is necessary to distinguish between warranties which give the customer assurance that the product complies with agreed upon specifications, and warranties which provide the customer with a distinct service (such as free repairs over a specified period).

A warranty which the customer purchases separately will always be a service warranty.

A service warranty is accounted for as a separate performance obligation and a portion of the transaction price is allocated to it.

A warranty which does not promise a service is simply accounted for in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets* (IFRS 15.B28–30).

When considering whether a warranty is standard or extended, IFRS 15 requires that the following factors are considered:

(a) Whether the provision of the warranty is a legal requirement; this would indicate that it is a standard warranty

(b) The length of the warranty period – the longer the period, the more likely it is to be an additional or extended warranty

(c) The nature of the tasks promised within the warranty and whether they relate to providing assurance that a product will function as intended

3.3 Principal versus agent

IFRS 15 specifically excludes amounts collected on behalf of third parties from the transaction price attached to a contract (IFRS 15.47).

Individually or in combination, the following criteria indicate that the entity is acting as an agent (IFRS 15.B37):

- Another party has the primary responsibility for providing the goods or services to the customer, or for fulfilling the order.
- The entity does not have the inventory risk before or after the customer order, during shipping or on return.
- The entity does not have discretion in establishing prices for the goods or services.
- The entity's consideration is in the form of commission.
- The entity is not exposed to credit risk on the amount due from the customer.

An entity is a principal if it controls the promised good or service before it is transferred to the customer. In this case, when the performance obligation is satisfied the entity recognises the revenue.

An entity is an agent if its performance obligation is to arrange for the provision of goods or services by another party. When this performance obligation is satisfied, it recognises revenue only for the fee or commission to which it is entitled (IFRS 15.B36).

Worked example: Agent or principal?

An entity runs a website which enables customers to buy goods from a range of suppliers. Prices are set by suppliers, and payments are processed through the entity's website. Customers pay in advance and goods are delivered directly from the supplier to the customer.

The entity receives a commission of 10% of the sales price and has no further obligation to the customer after arranging for the products to be shipped.

Requirement

Is the entity an agent or the principal?

Solution

The entity is acting as an agent based on the following points:

- Goods travel directly from the supplier to the customer, so the entity never has physical custody of them and does not bear the associated risk.
- The supplier, not the entity, has the obligation to the customer.
- The entity does not set prices or bear credit risk.
- The payment received by the entity is in the form of commission.

So the entity should only recognise the commission received from suppliers as revenue.

3.4 Goods and services provided in one contract

One marketing approach frequently used is to bundle together both goods and services into one transaction. For example, a car dealer may sell new cars with one year's free servicing and insurance.

In such cases:

- the components of the package which could be sold separately should be identified; and
- each should be measured and recognised as if sold separately.

IFRS 15 does not specifically state how each component should be measured but general principles require that each component should be:

- measured at its fair value; and
- recognised as revenue only when it meets the recognition criteria.

If the total of the fair values exceeds the overall price of the contract, an appropriate approach would be to apply the same discount percentage to each separate component.

Worked example: Goods and services

A car dealer sells a new car, together with 50 litres of fuel per month for a year and one year's servicing, for £27,000. The fair values of these components are: car £28,000, fuel £1,200 and servicing £800.

Requirement

How should the £27,000 be recognised as revenue?

Solution

The total fair value of the package is £30,000 (28,000 + 1,200 + 800) but is being sold for £27,000, a discount of £3,000 or 10%.

The discounted fair value of the car should be recognised as revenue upon delivery:

£28,000 × 90% = £25,200

The discounted fair value of the fuel should be recognised as revenue on a straight line basis over the next 12 months:

£1,200 × 90% = £1,080

The discounted fair value of the servicing should be recognised as revenue at the earlier of when the servicing is provided and the end of the year:

£800 × 90% = £720

Interactive question 7: Goods and services

An entity sells an item of equipment to a customer on 1 January 20X7 for £1.5 million. Due to the specialised nature of the equipment, the entity has agreed to provide free support services for the next two years, despite the cost to the entity of that support being estimated at £120,000 in total. The entity usually earns a gross margin of 20% on such support service contracts.

Requirement

How much revenue should the entity recognise for the year ended 30 April 20X7?

	£
Revenue:	

See **Answer** at the end of this chapter.

Interactive question 8: Servicing fees

On the last day of its current accounting period, Computer Ltd completes the handover of a new system to a client and raises an invoice for £800,000. This price includes after-sales support for the next two years, which is estimated to cost £35,000 each year. Computer Ltd normally earns a gross profit margin of 17.5% on such support activity.

Requirement

Calculate the revenue to be included in Computer Ltd's current year statement of profit or loss in respect of this sale.

		£
After-sales support Remainder		
Total selling price		
So the revenue from the sale in the current year is:		

See **Answer** at the end of this chapter.

3.5 Licenses

A license allows a customer to access intellectual property such as software, patents, trademarks, franchises, copyrights and media (eg, films).

The grant of a license may be accompanied by the promise to transfer other goods or services in the following circumstances:

(a) Where the promise to grant a licence is distinct, it forms a separate performance obligation from that for goods and services.

(b) Where the promise to grant a licence is a separate performance obligation, revenue is either recognised at a point in time or over time depending on the nature of the contract.

(c) Where the promise to grant a licence is not distinct from the promised goods and services, the goods, services and licence are combined as one single performance obligation (eg, software that requires ongoing upgrade services in order to function or a software hosting agreement on an internet site). This performance obligation may be satisfied at a point in time or over time and this should be determined in accordance with IFRS guidance (see section 2.9).

(d) Where the licence allows the customer access to the vendor's intellectual property as it exists at any given time in the licence period (ie, the vendor continues to support and update the intellectual property), this is a performance obligation satisfied over time.

(e) Where the licence allows the customer access to the vendor's intellectual property as it exists at the date the licence is granted, this is a performance obligation satisfied at a point in time.

Worked example: Licensing

A fast food company 'PizzaTheAction' grants a franchise licence to a customer, allowing the customer to use the PizzaTheAction brand and sell company products for a 10-year period. During the 10-year period, management at PizzaTheAction will perform customer analysis, continuously improve the product and advertise the brand, all of which will affect the franchise licence.

Requirement

Explain how the revenue arising from this transaction is recognised.

Solution

PizzaTheAction is providing access to its intellectual property as it exists throughout the licence period (ie, the customer will benefit from continuous improvements and marketing etc). Therefore the performance obligation is satisfied over time and PizzaTheAction recognises revenue over the licence period.

3.6 Royalties

A contract to license intellectual property may require as consideration a royalty that is measured by reference to sales or usage. In such cases, the seller recognises revenue when the later of the following events occurs:

- The subsequent sale or usage arises.
- The performance obligation to which some or all of the sales- or usage-based royalty has been allocated is satisfied (or partially satisfied).

3.7 Repurchase agreements

Under a repurchase agreement an entity sells an asset and has the option to repurchase it. This can come in one of three forms (IFRS 15.B64):

(a) An obligation to repurchase (a forward contract)

(b) A right to repurchase (a call option)

(c) An obligation to repurchase at the customer's request (a put option)

Under a **forward contract** or a **call option** the customer does not obtain control of the asset because that control is limited by the repurchase option. The contract is accounted for as a lease if the repurchase price is below the original selling price, or a financing arrangement if the repurchase price is equal to or above the original selling price (IFRS 15.B66).

Under a **put option**, if the customer does not have sufficient economic incentive to exercise the right to request repurchase, the agreement should be treated as if it were a sale with a right of return. If the customer **does** have sufficient economic incentive, for instance if the repurchase price is above the original selling price and above market value, the contract is treated as a financing arrangement (IFRS 15.B73).

Worked example: Repurchase agreement

An entity sold an investment property to a financial institution for £4 million when the fair value of the property was £5 million. Further investigation uncovered an agreement whereby the entity could repurchase the property after one year for £4.32 million.

Requirement

How should this transaction be accounted for?

Solution

The entity has a right to repurchase the property – a call option. The repurchase price is above the original selling price, so this is, in effect, a financing arrangement.

The sale of the property at 20% below fair value is sufficient to cast doubt on whether a real sale has been made. Also, the repurchase price is below fair value at the date of sale and represents a return to the financial institution of 8% ((£4.32m – £4m) as a percentage of £4 million) on the amount paid out.

The substance of the arrangement appears to be that the financial institution has granted the entity a one-year loan secured on the property, charging interest at 8%.

The transaction should be accounted for by:

- continuing to recognise the property as an asset;
- crediting the £4 million received to a liability account;
- recognising £0.32 million as a finance cost in profit or loss and crediting it to the liability account; and
- derecognising the liability when the £4.32 million cash is paid out.

Interactive question 9: Sale and repurchase

Builder Ltd specialises in building high quality executive flats in city centres. On 1 March 20X6 it sells a plot of building land to Finance plc, an unconnected company, for £1.5 million. Builder Ltd retains rights of access and supervision over the plot, the right to build on this land until 28 February 20X9 and the right to buy the plot back again on that date for £1.9 million. On 1 March 20X6 the plot is valued at £2.5 million.

Requirement

Explain how this sale transaction would be dealt with in Builder Ltd's financial statements for the year ended 28 February 20X7.

See **Answer** at the end of this chapter.

3.8 Consignment arrangements

In a consignment arrangement, a dealer does not obtain control of an asset. Such arrangements are common in the motor industry. Often a car manufacturer will enter into an arrangement with a car dealer such that the dealer takes and displays vehicles with a view to selling them to a customer. In such situations, the manufacturer cannot recognise any revenue because the dealer does not obtain control of the cars at the point of delivery.

The following are indicators that an arrangement is a consignment arrangement:

- The product is controlled by the seller (manufacturer) until a specified event occurs (eg, the product is sold onwards or a specified period of time expires).
- The seller (manufacturer) can require the return of the product or transfer it to another party.
- The customer (dealer) does not have an unconditional obligation to pay for the product.

3.9 Bill and hold arrangements

Under these arrangements, an entity bills the customer for the product but delivery is delayed with the agreement of the customer, perhaps because the customer is short of space. In this case, the entity must determine the point in time at which it has satisfied its performance obligation by transferring control of the product to the customer. It may be that the customer is still able to exercise control without having physical possession of the product.(IFRS 15 .B79)

Control may pass at the point of delivery or when the product is shipped or at an earlier date ie, the customer may obtain control even though the seller has physical possession of the product.

All the following IFRS 15 criteria must have been met in a bill and hold arrangement, in order for control to be said to have passed:

(a) There must be a substantive reason for the bill and hold arrangement, for example, the customer has requested it.

(b) The product must be identified as belonging to the customer.

(c) The product must be ready for physical transfer to the customer.

(d) The seller must not be able to use the product or transfer it to another customer.

If these criteria are met, enabling revenue to be recognised on a bill and hold basis, the seller should consider whether to allocate a proportion of the transaction price to the provision of a storage service.

Interactive question 10: Bill and hold

Walbrooke Engineering plc enters into a contract with Southfield Beverages Ltd on 1 January 20X8 for the sale of a bottling machine and spare parts. It takes two years to manufacture these and on 31 December 20X9 the customer pays for both the machine and the spare parts, but only takes physical possession of the machine. The customer inspects and accepts the spare parts, but requests that Walbrooke Engineering continues to store them at its warehouse.

Requirement

Explain when Walbrooke Engineering should recognise revenue in respect of this transaction.

See **Answer** at the end of this chapter.

3.10 Options for additional goods and services

An option in a sales contract may grant the customer the right to acquire additional goods or services for free or at a discount. In some cases this may take the form of 'loyalty points'. For example, airlines often give passengers loyalty points when they buy a flight. When enough loyalty points are acquired, they can be redeemed for a free flight.

The option to acquire additional goods or services forms a separate performance obligation if the option can only be obtained by entering into the initial sales contract.

In this case, part of the transaction price is allocated to the option to acquire additional goods or services, and part is allocated to the goods or services that are the subject of the sales contract.

Revenue is recognised in respect of the option to acquire additional goods or services at the earlier of:

- the date on which the additional goods or services are provided;
- the date on which the option to acquire the additional goods or services expires.

The allocation of transaction price to the option is based on the stand-alone selling price of the additional goods or services, taking account of the discount and adjusted for the likelihood that the option will be exercised.

If the option granted to the customer does not offer a discount, it is treated as a marketing offer and no contract exists until the customer exercises the option to purchase.

Worked example: Customer loyalty scheme

GymGo Ltd, a 'pay as you go' gym operates a customer loyalty scheme whereby if a customer pays for nine visits and has a loyalty card stamped, the tenth visit is provided free of charge.

During 20X7, customers visit the gym a total of 94,995 times, paying £10 per visit, so earning the right to a maximum of 10,555 (94,995/9) free visits, each of which has an average stand-alone price of £10. The gym expects 7,400 of the free visits to be claimed and by 31 December 20X7, 4,350 have been claimed.

Requirement

Explain how revenue is recognised by GymGo Ltd.

Solution

The promise to provide a free tenth visit is a performance obligation, and total revenue of £949,950 (94,995 × £10) is allocated between visits to the gym by customers and the loyalty scheme.

Revenue is allocated to the provision of 'stamps' based on the expected take up rate and the stand- alone selling price basis ie, based on a total stand-alone selling price of £74,000 (7,400 × £10):

		£
Gym visits	£949,950 × (949,950/(949,950 + 74,000))	881,298
Loyalty stamps	£949,950 × (74,000/(949,950 + 74,000))	68,652
		949,950

At 31 December 20X7, 4,350 of the expected 7,400 free visits have been claimed, therefore of the £68,652 transaction price allocated to loyalty stamps:

- £40,356 (4,350/7,400 × £68,652) is recognised as revenue; and
- £28,296 is recognised as a contract liability for the unredeemed loyalty stamps.

Therefore total revenue recognised in 20X7 is £921,654 (881,298 + 40,356).

3.11 Non-refundable upfront fees

A non-refundable upfront fee is often charged at the beginning of a contract, such as joining fees in health club membership contracts.

In many cases upfront fees do not relate to the transfer of any promised good or service, but are simply advance payments for **future** goods or services. In this case revenue is recognised when the future goods or services are provided.

If the fee relates to a good or service the entity should evaluate whether or not it amounts to a separate performance obligation. This depends on whether it results in the transfer of an asset to the customer. The fee may relate to costs incurred in setting up a contract, but these setup activities may not result in the transfer of services to the customer.

4 Audit focus

Section overview

This section looks at audit procedures relevant when considering the appropriateness of the accounting treatment adopted for construction contracts.

4.1 Audit procedures for testing IFRS 15

Stage of IFRS 15	Suggested audit procedures
Step 1 Identify the contract(s) with a customer.	• Obtain copies of **contracts** between entities and customers • Inspect contracts to confirm they are **legally binding** and **effective** for the year of audit • For **implied contracts** (such as retail contracts) clarify the likely contractual terms to establish rights and responsibilities in each case
Step 2 Identify separate performance obligations.	• Confirm the **goods** or **services** to be transferred, either individually or as part of a series, by reference to the contracts in place • Confirm whether any of the goods or service are **not distinct** by reference to the contracts in place and if separate bundles
Step 3 Determine the transaction price.	• Identify the amount of **consideration** by reference to the contract • Where appropriate, confirm the split between **variable** and **fixed** elements and re-calculate any variable amounts by reference to the contract terms • Test the hypothesis that variable consideration is **highly probable** by reviewing the reasonableness of the underlying assumptions used in the entity's calculations
Step 4 Allocate transaction price to performance obligations.	• Confirm **stand-alone** prices to individual elements of the contract as performance obligations are settled • In the case of **estimated stand-alone prices**, test the assumptions underpinning the calculations used by the entity for reasonableness
Step 5 Recognise revenue as or when each performance obligation is satisfied.	• For performance obligations satisfied **at a point in time** (such as retail sales) confirm the occurrence of the event required (such as the sale itself) by reference to supporting documentation (For performance obligations satisfied **over time** refer to section 4.2 below.)
Other tests	• For **deferred consideration**, confirm the proportion split between the value of the goods on the date of sale and the financing income by reference to the contract and testing the reasonableness of the entity's calculations for recognising revenue (such as interest rates for estimating fair value)
Returns	• Review contract/terms of sale and confirm that this is allowed • For a sample of goods inwards, determine whether any relate to returns and ensure no revenue has been recognised for such goods • Review returns activities in the next reporting period to ensure revenue has not been overstated in relation to returns
Warranties	• For service warranties, review sales activity to identify evidence of related performance obligations and identify revenue allocated to such warranties
Revenue collected on behalf of third parties	• Establish existence of any third parties for whom revenue would be collected (ideally during the process of understanding the entity at the planning stage) • For a sample of revenue items, confirm the revenue is not due to be passed on to any third parties identified

Stage of IFRS 15	Suggested audit procedures
Bundled services, licences, royalties and repurchase agreements	• Clearly complex, these will require a review of contracts/terms of sale to establish their likelihood and conditions and the audit team briefed to include these in audit tests as appropriate
Consignment arrangements	• Consider the existence of any **indicators** of consignment arrangements, such as: - Confirming who **controls** the product and what (if any) **conditions** need to have occurred for control to be passed on - Clarifying who can require the **return** of a product or **transfer** it to a third party
Bill and hold arrangements	• Consider the **existence** of such arrangements and if present, review the conditions required by IFRS 15 have been met: - Confirm that the customer **owns** the products stored by the seller by reference to the contract terms, and obtain confirmation from the customer that they are happy for the seller to **hold** them - Inspect the agreement between the seller and customer to confirm the products can be **accessed at any time** and **not transferred** to another customer
Non-refundable upfront fees	• For a sample of revenues recognised during the reporting period, determine whether any related to upfront fees • Confirm any upfront fees recognised that relate to performance obligations have now been satisfied (for example, in a health club, that services have been provided)

Professional skills focus: Structuring problems and solutions

Just as the financial accountant must apply the five-stage structure of IFRS 15 in determining when and in what amount to recognise revenue, the auditor must also apply this structured approach to selecting audit procedures at each of the five stages.

Exam focus note

It is possible that you could be examined on IFRS 15 and that you will need to know the auditing implications of this complex standard: here are two illustrations since it became an examinable standard that show just how complex the accounting for revenue can actually be for the auditor.

For example a requirement to account for a customer reward scheme which included specific performance obligations in relation to the redemption of the points earned by customers under the scheme. What if auditing issues are tested for this? You might have been required to consider procedures such as obtaining details about the scheme to confirm the criteria in place and challenging the client on any of the information supplied (such as confirming how many of the points earned had been redeemed and recalculating the client's estimates of points not yet redeemed that would need to be recognised as a contract liability).

For example, for another incentive scheme, this time for a listed caterer whose customers can pay to join a club which offers discounts for future events booked within a set period of time. The scenario presented different revenue streams, each with their own performance obligations, which required candidates to discuss audit risks related to cut-off and other recognition issues (which in turn were likely to indicate questionable management integrity and manipulation).

4.2 Audit procedures for contracts in which performance obligations are satisfied over time ('construction contracts')

Remember, under IFRS 15, the entity recognises revenue in such cases by measuring **progress** towards complete satisfaction of the performance obligation. Progress can be measured using **output methods** (measuring the value to the customer of goods or services transferred to date) or **input methods** (measuring the cost to the entity of goods or services transferred to date)(IFRS 15.B14).

The following audit procedures will be relevant:

- Confirm **contract price** to contract agreed between client and customer
- Determine any amounts of **conditional revenue**/**costs** including the associated conditions
- Confirm the **progress** to date of the work completed, including any potential delays or problems
- Confirm **costs incurred to date** (**inputs**) by reference to management accounts, invoices, budgets and other relevant documentation
- Identify any **expenditure not supporting fulfilment of the contract** by inspecting board minutes, management accounts or other documentation (such as legal correspondence)
- Confirm **total costs estimated for contract** to ensure no planned overspends have been identified (again, budgets, board minutes or management accounts can be inspected)
- Confirm the **amounts of contract work certified as complete** (**outputs**) at the year end by reference to relevant documentation (such as surveyors' reports or client estimates)

Interactive question 11: Construction contracts

Construction Co has entered into a fixed price contract to construct an office block. Construction commenced on 1 March 20X6 and is expected to take 36 months. You are auditing the financial statements for the year ended 31 December 20X6.

The contract price is made up as follows:

	£'000
Contract price	600
Incentive payment if completed on time	40
	640

Total contract costs were originally estimated to be £470,000. At the end of 20X6 this estimate has increased to £570,000 due to extra costs incurred to rectify a number of construction faults.

At the end of 20X6 the contract was assessed as being 30% complete. The draft financial statements show that revenue of £192,000 has been recognised in respect of this contract.

Requirements

For the year ended 31 December 20X6:

(a) Identify the audit issues you would need to consider

(b) List the audit procedures you would perform

See **Answer** at the end of this chapter.

Context example: Carillion

In July 2017, UK construction firm Carillion collapsed leaving over £1 billion in debts and a number of unfulfilled contracts, as well as a significant unfunded pension scheme. A UK parliamentary committee interviewed the company's directors, internal auditors Deloitte, and external auditors KPMG and asked why this could not have been foreseen in March 2017, only four months earlier, when the 2016 financial statements were signed off, despite a number of so-called 'red flags' which had been identified by investors. Carillion went into liquidation in January 2018.

These 'red flags' included poor corporate governance, uncertainty over complex accounting practices for goodwill and revenue (including the cash-flows on individual contracts) and inadequate site visits as part of managing high-profile construction contracts clients.

The imminent need to adopt IFRS 15 from 2018 onwards is considered to be one of the key triggers for these events. In its interim financial statements for the six months to 30 June 2017, the company estimated that the adoption of IFRS 15 would reduce reserves by up to £150 million, an amount that could have seen operating profits for 2017 almost entirely eliminated. Of course, revenue recognition wasn't the only issue facing Carillion: insufficient cash-flow from an excess of loss-making contracts had made the company vulnerable and this could be seen by the frequency with which their shares were being shorted by investors keen to capitalise on an already doomed share price.

Overall, the fundamental need to communicate position and performance (and viability for that matter) in a true and fair manner must never be forgotten by companies, regulators, investors and auditors and the Carillion case has framed the discussion for how auditing, reporting and governance should evolve.

(Sources: Shoaib, A. (26 February 2018) Carillion inquiry: missed red flags, aggressive accounting and the pension deficit. *AccountacyAge*. [Online]. Available from: www.accountancyage.com/2018/02/26/carillion-inquiry-missed-red-lights-aggressive-accounting- pension-deficit/;

O'Connell, D. (20 January 2018) Carillion: the signals that the company was going bust. *BBC News Website*. [Online]. Available from https://www.bbc.co.uk/news/business-42744949;

Ryland, P. (26 September 2019) Cash vs concept. Investor's Chronicle [Online]. Available from: https://www.investorschronicle.co.uk/shares/2019/09/26/cash-vs-concept/;

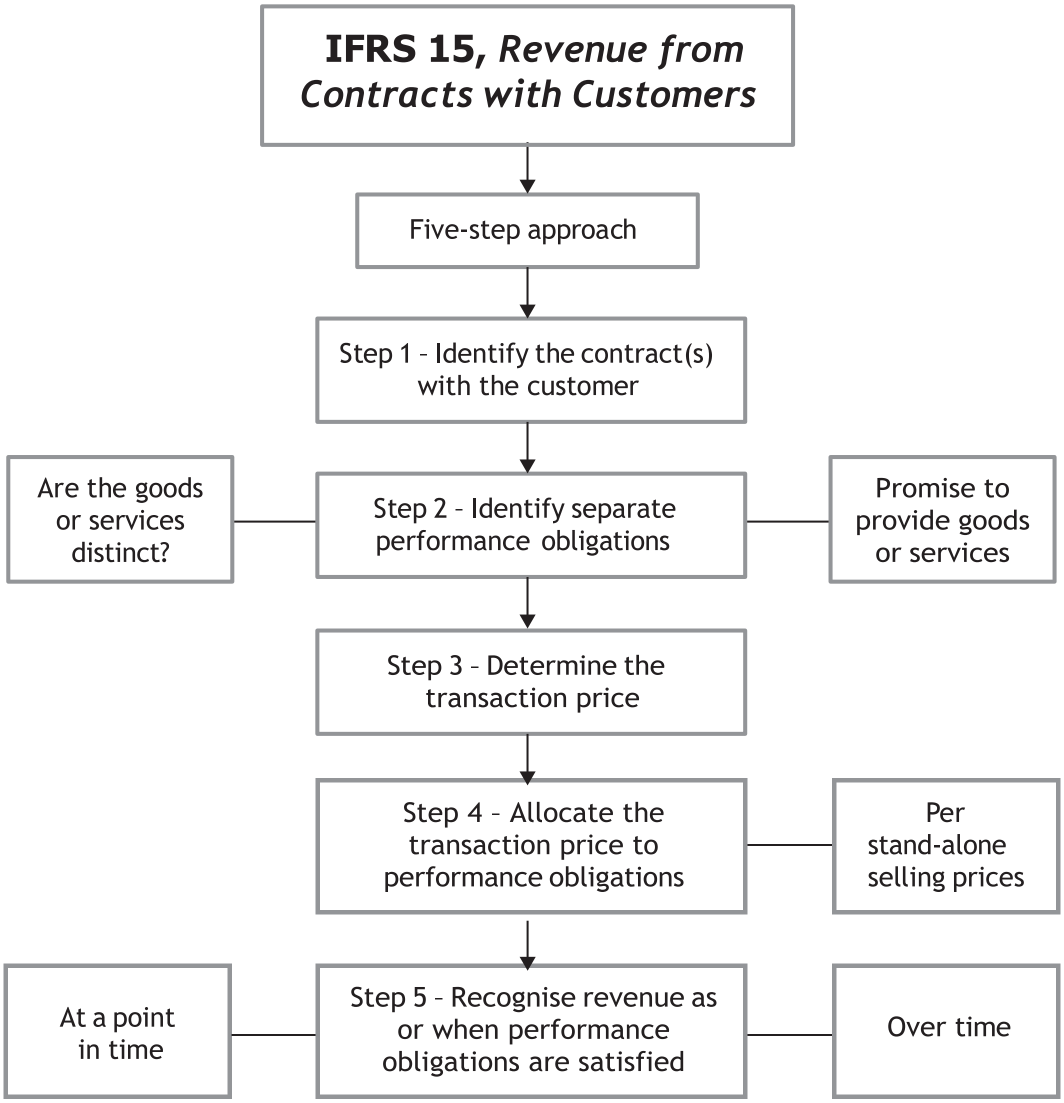
Carillion plc (29 September 2017) Financial results for the six months ended 30 June 2017 Strategic and operational review update [Online]. Available from: https://www.rns-pdf.londonstockexchange.com/rns/2047S_1-2017-9-29.pdf

[All accessed 23 June 2021])

Professional skills focus: Concluding, recommending and communicating

The worked example above (Carillion) illustrates a situation where the professional skills of concluding, recommending and communicating were not applied. Red flags over revenue were identified, but the wrong conclusion drawn.

Summary


IFRS 15, *Revenue from Contracts with Customers*
Five-step approach
Step 1 - Identify the contract(s) with the customer
Are the goods or services distinct?
Step 2 - Identify separate performance obligations
Promise to provide goods or services
Step 3 - Determine the transaction price
Step 4 - Allocate the transaction price to performance obligations
Per stand-alone selling prices
At a point in time
Step 5 - Recognise revenue as or when performance obligations are satisfied
Over time

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Can you list and apply the IFRS 15 five-step model for recognising revenue? (Topic 2)
2.	What does 'distinct' mean in the context of performance obligations? (Topic 2)
3.	Can you deal with performance obligations satisfied over time? (Topic 2)
4.	What is the IFRS 15 treatment for sales with a right of return? (Topic 2)
5.	How would each of IFRS 15's five steps be audited? (Topic 5)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Southwell	A sale and repurchase question with a financing element, this is a short question to get you started.
Taplop	A comprehensive question on variable consideration, this is an exam- standard test of this topic (though not exam-style as it is much shorter).
Clavering	Part (a) deals with the issue of whether control has transferred, which it must in order to satisfy a performance obligation. There is scope for different interpretations. Part (b) deals with identifying performance obligations and allocating the transaction price.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios to help you improve knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Wayte	This requires you to separate out performance obligations to determine the appropriate timing of revenue recognition.
Solvit	This tests the five-step process in detail and also the audit aspects.
Roada	A comprehensive, detailed question on IFRS 15, focusing mainly on performance obligations satisfied over time, but with a number of different revenue streams.
Panther Metals	This question requires use of the data analytics software to identify revenue issues.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries.

Once you have attempted these questions, you can continue your studies by moving onto the next chapter.

Technical reference

1 IFRS 15, Revenue from Contracts with Customers

Revenue is income arising in the course of an entity's ordinary activities. – **IFRS 15 Appendix A**

Five-step approach is used: – **IFRS 15 (IN7)**

- Identifying the contract – **IFRS 15 (9)**
- Identifying the performance obligations – **IFRS 15 (22)**
  - Satisfaction of performance obligations – **IFRS 15 (31)**
  - Performance obligations satisfied over time – **IFRS 15 (35)**
  - Performance obligations satisfied at a point in time – **IFRS 15 (38)**
- Determining the transaction price – **IFRS 15 (47)**
- Allocating the transaction price to the performance obligations – **IFRS 15 (73)**
- Recognising revenue as/when obligations are satisfied – **IFRS 15 (31)**

Incremental costs of a contract are recognised. – **IFRS 15 (91–94)**

Costs incurred to fulfil a contract are recognised as an asset if and only if all of certain criteria are met: – **IFRS 15 (95)**

- The costs relate directly to a contract (or a specific anticipated contract);
- The costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future; and
- The costs are expected to be recovered.

Costs include direct labour, direct materials, and the allocation of overheads that relate directly to the contract. – **IFRS 15 (97)**

The asset recognised in respect of the costs to obtain or fulfil a contract is amortised on a systematic basis that is consistent with the pattern of transfer of the goods or services to which the asset relates. – **IFRS 15 (99)**

IFRS 15 gives further guidance on: – **IFRS 15 (App B)**

- Performance obligations satisfied over time
- Methods for measuring progress towards complete satisfaction of a performance obligation
- Sale with a right of return
- Warranties
- Principal versus agent considerations
- Customer options for additional goods or services
- Customers' unexercised rights
- Non-refundable upfront fees
- Licensing
- Repurchase agreements
- Consignment arrangements
- Bill-and-hold arrangements
- Customer acceptance
- Disclosures of disaggregation of revenue

Self-test questions

Answer the following questions.

1 Webber

Webber sells two types of product, the Sleigh and the Sled. Webber sells the sleigh as an agent of Caplin receiving commission of 15% on selling price. Webber sells the sled as principal at a gross margin of 30%.

The following information relates to the year ended 30 September 20X8.

	Sleighs	**Sleds**
	£	**£**
Total sales	200,000	75,000
Gross profit	60,000	22,500

Requirement

According to IFRS 15, *Revenue from Contracts with Customers* what revenue should Webber recognise in total for Sleighs and Sleds for the year ended 30 September 20X8?

2 Alexander

On 1 January 20X0, Alexander Ltd supplied goods to David Ltd for an agreed sum of £600,000. This amount becomes payable on 31 December 20X2. David Ltd could have bought the goods for cash of £450,000 on 1 January 20X0. The imputed rate of interest to discount the receivable to the cash sales price is 10%.

Requirement

In accordance with IFRS 15, *Revenue from Contracts with Customers* what amounts for revenue and interest income should Alexander Ltd record in profit or loss relating to this transaction for the year ended 31 December 20X0?

3 Southwell

Southwell Ltd, a manufacturing company, sold a property with a carrying amount of £4.5 million for
£5 million to Financier Ltd on 1 January 20X4. Southwell Ltd retains the right to occupy the property and has an option to repurchase the property after two years for £6 million. Property prices are expected to rise and the current market value is £8 million. The annual rate for 20% over two years is 9.5%.

Requirement

In accordance with IFRS, 15 *Revenue from Contracts with Customers* what should be recognised in the financial statements relating to this transaction for the year ended 31 December 20X4?

4 White Goods

White Goods Ltd sells an electrical appliance for £2,400 on 1 October 20X7 making a mark up on cost of 20%. The customer is given a one-year interest-free credit period. White Goods Ltd has a cost of capital of 9%.

Requirement

In accordance with IFRS 15, *Revenue from Contracts with Customers*, what amount should the company recognise as revenue from the sale of the appliance in profit or loss for the year ended 31 December 20X7?

5 Tree

You are the accountant of Tree, a listed limited liability company that prepares consolidated financial statements. Your Managing Director, who is not an accountant, has recently attended a seminar at which key financial reporting issues were discussed. She remembers being told the following.

- Financial statements of an entity should reflect the substance of its transactions.
- Revenue from the contracts with customers should only be recognised when certain conditions have been satisfied. Transfer of legal title to the goods is not necessarily sufficient for an entity to recognise revenue from their 'sale'.

The year end of Tree is 31 August. In the year to 31 August 20X1, the company entered into the following transactions.

Transaction 1

On 1 March 20X1, Tree sold a property to a bank for £5 million. The market value of the property at the date of the sale was £10 million. Tree continues to occupy the property rent-free. Tree has the option to buy the property back from the bank at the end of every month from 31 March 20X1 until 28 February 20X6. Tree has not yet exercised this option. The repurchase price will be £5 million plus
£50,000 for every complete month that has elapsed from the date of sale to the date of repurchase. The bank cannot require Tree to repurchase the property and the facility lapses after 28 February 20X6. The directors of Tree expect property prices to rise at around 5% each year for the foreseeable future.

Transaction 2

On 1 September 20X0, Tree sold one of its branches to Vehicle for £8 million. The net assets of the branch in the financial statements of Tree immediately before the sale were £7 million. Vehicle is a subsidiary of a bank and was specifically incorporated to carry out the purchase – it has no other business operations. Vehicle received the £8 million to finance this project from its parent in the form of a loan.

Tree continues to control the operations of the branch and receives an annual operating fee from Vehicle. The annual fee is the operating profit of the branch for the 12 months to the previous 31 August less the interest payable on the loan taken out by Vehicle for the 12 months to the previous 31 August. If this amount is negative, then Tree must pay the negative amount to Vehicle.

Any payments to or by Tree must be made by 30 September following the end of the relevant period. In the year to 31 August 20X1, the branch made an operating profit of £2,000,000. Interest payable by Vehicle on the loan for this period was £800,000.

Requirements

5.1 Explain the conditions that need to be satisfied before revenue can be recognised. You should support your answer with reference to IFRS 15.

5.2 Explain how the transactions described above will be dealt with in the consolidated financial statements (statement of financial position and statement of profit or loss and other comprehensive income) of Tree for the year ended 31 August 20X1 in accordance with IFRS 15.

6 Taplop

Taplop supplies laptop computers to large businesses. On 1 July 20X5, Taplop entered into a contract with TrillCo, under which TrillCo was to purchase laptops at £500 per unit. The contract states that if TrillCo purchases more than 500 laptops in a year, the price per unit is reduced retrospectively to £450 per unit. Taplop's year end is 30 June.

- As at 30 September 20X5, TrillCo had bought 70 laptops from Taplop. Taplop therefore estimated that TrillCo's purchases would not exceed 500 in the year to 30 June 20X6, and would therefore not be entitled to the volume discount.
- During the quarter ended 31 December 20X5, TrillCo expanded rapidly as a result of a substantial acquisition, and purchased an additional 250 laptops from Taplop. Taplop then estimated that TrillCo's purchases would exceed the threshold for the volume discount in the year to 30 June 20X6.

Requirements

Calculate the revenue Taplop would recognise in:

(a) The quarter ended 30 September 20X5

(b) The quarter ended 31 December 20X5

Your answer should apply the principles of IFRS 15, *Revenue from Contracts with Customers*.

7 Clavering

Clavering Leisure Co owns and operates a number of hotels. The company is preparing its financial statements for the year ended 31 May 20X3, and has come across the following issues.

(1) One of the hotels owned by Clavering Leisure is a complex which includes a theme park and a casino as well as a hotel. The theme park, casino and hotel were sold in the year ended 31 May 20X3 to Manningtree Co, a public limited company, for £200 million but the sale agreement stated that Clavering Leisure would continue to operate and manage the three businesses for their remaining useful life of 15 years. The residual interest in the business reverts back to Clavering Leisure after the 15-year period. Clavering Leisure would receive 75% of the net profit of the businesses as operator fees, and Manningtree would receive the remaining 25%. Clavering Leisure has guaranteed to Manningtree that the net minimum profit paid to Manningtree would not be less than £15 million per year.

(2) Clavering Leisure has recently started issuing vouchers to customers when they stay in its hotels. The vouchers entitle the customers to a £30 discount on a subsequent room booking within three months of their stay. Historical experience has shown that only one in five vouchers are redeemed by the customer. At the company's year end of 31 May 20X3, it is estimated that there are vouchers worth £20 million which are eligible for discount. The income from room sales for the year is £300 million and Clavering Leisure is unsure how to report the income from room sales in the financial statements.

Requirement

Advise Clavering Leisure on how the above accounting issues should be dealt with in its financial statements in accordance with IFRS 15, *Revenue from Contracts with Customers*.

8 Rockwye

Rockwye is a manufacturer of luxury watches which it sells to customers via a number of independent retailers. Rockwye recognises revenue and derecognises inventory when it supplies each retailer with deliveries of watches for display. Watches are then displayed by retailers at a price set by the manufacturer – once a watch is sold to a customer, the retailer passes the revenue back to Rockwye. Any unsold watches are returned to Rockwye after a period of 11 months.

Requirement

Comment on the accounting treatment in operation at Rockwye and recommend suitable audit procedures that you should undertake.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

Magazine revenue: £16,000 **Explanation**

Revenue for the magazines should be recognised in the periods in which they are despatched, assuming the items are of similar value in each period. Despatch of the magazine constitutes satisfaction of the performance obligation. Thus the revenue to be recognised in the year ended 31 March 20X7 is £48,000 × 4/12 = £16,000.

Answer to Interactive question 2

Revenue: £nil

Explanation

Revenue should be recognised when the drills are delivered to the customer. This is the point at which the performance obligation is satisfied. Until then no revenue should be recognised and the deposits should be carried forward as deferred income.

Answer to Interactive question 3

(a) **Costs to complete are £90,000**

This is a contract with performance obligations satisfied over time and 33% of the performance has been completed to date.

Revenue can be recognised on the output basis by the percentage of completion method, so 33% of £210,000 = £69,300.

Note: The project is profitable overall (total revenue £210,000, total costs £135,000), so no provision for a contract loss need be made.

(b) **Costs to complete cannot be estimated reliably**

As the outcome of the overall contract cannot be estimated reliably, revenue is recognised to the extent of the costs incurred which are recoverable ie, £40,000. The current period therefore recognises the contract loss to date of £5,000.

Answer to Interactive question 4 Contract revenue: £60,000 **Explanation**

If the outcome of a services transaction cannot be estimated reliably, revenue should only be recognised to the extent that expenses incurred are recoverable from the customer.

Answer to Interactive question 5

The Sales Director wishes to recognise the sale as early as possible. However, following IFRS 15, *Revenue from Contracts with Customers*, revenue from the sale should only be recognised when the performance obligations in the contract have been satisfied.

Performance obligations in the contract

The contract contains a promise to deliver the caravan and a promise to deliver additional goods free of charge. These are distinct promises and therefore the contract contains two performance obligations.

Transaction price

The transaction price is made up of three elements.

A significant financing component must be considered where consideration is received more than 12 months before or after the date on which revenue is recognised (being the delivery date, 1 August

20X7). Therefore the payment on 1 August 20X9 must be discounted to present value at 1 August 20X7.

	£
Deposit	3,000
Payment on 1.8.X7 (the delivery date)	15,000
Payment on 1.8.X9 (£12,000/1.1^2)	9,917
	27,917

Allocation to performance obligations

The transaction price is allocated based on standalone selling prices:

Caravan	30,000/31,500 × £27,917	=	£26,588
Free equipment	1,500/31,500 × £27,917	=	£1,329

Recognition of revenue

The two performance obligations are satisfied simultaneously on 1 August 20X7, and therefore all revenue is recognised on this date.

Journal entries are as follows:

1 May 20X7

The receipt of cash in the form of the £3,000 deposit is recognised on receipt as a contract liability (deferred income) in the statement of financial position by:

DEBIT	Bank	£3,000	
CREDIT	Contract liability (deferred income)		£3,000

1 August 20X7

Revenue is recognised together with payment of the first £15,000. The contract liability is transferred to be revenue:

DEBIT	Bank	£15,000	
DEBIT	Contract liability	£3,000	
DEBIT	Receivable	£9,917	
CREDIT	Revenue		£27,917

Note: This question is rather fiddly, so do not worry too much if you didn't get all of it right. Read through our solution carefully, going back to first principles where required.

Answer to Interactive question 6

6.1 **Account for sale**

- Bags Galore Ltd expects 3 bags (6% × 50) to be returned.
- Therefore on 28 January 20X9 revenue is recognised in relation to 47 bags, giving a total of £39,950 (47 × £850).
- A refund liability of £2,550 (3 × £850) is recognised.
- The cost of 47 bags of £18,800 (47 × £400) is transferred to cost of sales. The remaining 3 bags are recognised as an asset (the right to recover the bags) at cost of £1,200 (3 × £400). The 'right to recover' asset is measured at the original cost of the bags that are expected to be returned because, even in the 'Fabulous February' sale, they are capable of being sold for £425 (50% × £850) ie, more than cost.

The required accounting entries are:

DEBIT	Bank (50 × £850)	£42,500	
CREDIT	Revenue		£39,950
CREDIT	Refund liability		£2,550

To recognise the sale of bags and expectation that 6% will be returned.

DEBIT	Asset (right to recover inventory)	£1,200	
DEBIT	Cost of sales (47 × £400)	£18,800	
CREDIT	Asset (inventory)		£20,000

To recognise the transfer of items of inventory that are not expected to be returned to become cost of sales and that are expected to be returned to become assets (the right to recover the 3 bags).

6.2 If the selling price of the bags were reduced to £340 (40% × £850):

- The revenue and refund liability would be recorded as before.
- The retained asset would be measured at £1,020 (3 × £340), so resulting in a write down of the carrying amount of inventory in profit or loss.

Answer to Interactive question 7

	£
Revenue:	
- Sale of goods (W)	1,350,000
- Sale of services (W)	25,000
	1,375,000

WORKING

	£
After-sale support (120,000/ (100% – 20%))	150,000
Remainder = sale of goods (bal fig)	1,350,000
Total revenue	1,500,000

Revenue for sale of services recognised in the four months to 30 April 20X7 should be £150,000/2 years × 4/12 = £25,000

Answer to Interactive question 8

	£
After-sales support (2 × (35,000/82.5%))	84,848
Remainder	715,152
Total selling price	800,000
So the revenue from the sale in the current year is:	715,152

Answer to Interactive question 9

Sale transaction

- As there is an option to repurchase, this is a call option with a repurchase price above the original selling price, so it is treated as a financing arrangement.
- Through the rights of access and supervision, together with the right to build on the land, Builder Ltd has retained the risks and rewards of ownership over the building plot, so should continue to show it as an asset in its statement of financial position.
- The fact that the consideration for the sale on 1 March 20X6 is so far below the valuation is further evidence that the transaction is in substance a three-year loan, with the £400,000 difference between the selling and repurchase prices being interest on the loan.
- The right to repurchase in the future for much less than the current valuation (making the exercise of the repurchase right almost a certainty) is further evidence that this is not a real sale.
- So Builder Ltd will show the building plot in its 28 February 20X7 statement of financial position as a current asset (as it will be realised in the normal course of its operating cycle) at its original acquisition cost (not given in the Interactive question).
- In the same statement of financial position it will show the £1.5 million received on 1 March 20X6 as a liability, together with any unpaid part of the £400,000 interest which is attributable to the first year of the loan.
- The appropriate part of the total interest will be charged to profit or loss for the year ended 28 February 20X7.

Answer to Interactive question 10

The contract contains three performance obligations – transfer of the machine, transfer of the spare parts and the custodial services. The transaction price is allocated to the three performance obligations and revenue is recognised when (or as) control passes to the customer.

The machine and the spare parts are both performance obligations satisfied at a point in time, this being 31 December 20X9. In the case of the spare parts, the customer has paid for them, the customer has legal title to them and the customer has control of them as they can remove them from storage at any time.

The custodial services are a performance obligation satisfied over time, so revenue will be recognised over the period during which the spare parts are stored.

Answer to Interactive question 11

(a) **Audit issues**

- Whether revenue recognised to date includes a proportion of the incentive payment. This would only be appropriate if it is probable that this income will be received.
- Total costs to complete have been increased during the year due to rectification costs. There is a risk that there may be other rectification costs which have yet to be identified.
- Whether the accounting treatment of the revenue recognised is in accordance with IFRS 15. The current figure of £192,000 appears to be based on 30% of the expected total revenue (640 × 30%) but it is unclear where this 30% has come from. If revenue is being measured on costs incurred to date (input basis) the additional £100,000 of contract costs may not be allowable as part of this calculation. Similarly, if certified as complete (output basis) on a pro- rated time basis, the contract is only 10 months old – this would give a percentage of 10/36 = 27.8% which could lead to overstated revenue.

(b) **Audit procedures**

- Agree the contract price and incentive payment to the sales contract.
- Discuss with management the basis on which they have recognised the incentive payment and review their performance on other similar contracts to determine the likelihood of the contract being completed on time.
- Establish the basis on which the percentage completion of 30% has been determined. If a surveyor has been used to make this estimate assess the extent to which this evidence can be relied on.
- Discuss with management the nature of the rectification costs and assess the likelihood of other similar additional costs being incurred. Obtain a schedule of these and agree to supporting documentation.
- Review management calculations regarding costs to complete and seek corroboration for any assumptions made.
- Discuss with management the revenue recognition policy adopted. If material to the financial statements the figures should be revised in accordance with IFRS 15.

Answers to Self-test questions

1 Webber

Revenue

	£
Revenue recognised as agent (£200,000 × 15%)	30,000
Revenue recognised as principal	75,000
Total revenue	105,000

2 Alexander

At the time of supply, revenue is recognised for the cash sale price of £450,000. Interest will then be accrued until payment is made. For the year ended 31 December 20X0 the interest charge is £450,000 × 10% = £45,000.

3 Southwell

As there is an option to repurchase, this is a call option with a repurchase price above the original selling price, so it is treated as a financing arrangement.

Initial loan:	DEBIT	Cash	£5m
	CREDIT	Loan	£5m
Interest:	DEBIT	Interest (Profit or loss) (5m × 9.5%)	£0.475m
	CREDIT	Loan	£0.475m

Total loan liability is £5.475 million.

4 White Goods

The amount receivable discounted to present value = £2,400 × 1/1.09 = £2,202

This is recognised as income on 1 October 20X7. The difference between this and the sale proceeds (2,400 – 2,202 = 198) is treated as interest and will be recognised over the 12-month interest-free credit period.

5 Tree

5.1 IFRS 15, *Revenue from Contracts with Customers* states the following (IFRS 15.35):

Revenue is recognised when (or as) a performance obligation is satisfied. The entity satisfies a performance obligation by transferring **control** of a promised good or service to the customer. A performance obligation can be satisfied **at a point in time**, such as when goods are delivered to the customer, or **over time**. An obligation satisfied **over time** will meet one of the following criteria:

- The customer simultaneously receives and consumes the benefits as the performance takes place.
- The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.
- The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

The amount of revenue recognised is the amount allocated to that performance obligation. An entity must be able to reasonably measure the outcome of a performance obligation before the related revenue can be recognised. In some circumstances, such as in the early stages of a contract, it may not be possible to reasonably measure the outcome of a performance obligation, but the entity expects to recover the costs incurred. In these circumstances, revenue is recognised only to the extent of costs incurred.

5.2 **Transaction 1**

Tree has the option to repurchase the property but cannot be required to do so. This is a call option in which the repurchase price is equal to or above the original selling price, so it should be accounted for as a financing arrangement.

Tree has not transferred control of the property to the bank as it still has the right to exercise this option, so no performance obligation has been satisfied that could justify the recognition of revenue.

The transaction is essentially a **loan secured on the property**, rather than an outright sale. The £50,000 payable for each month that the bank holds the property is **interest** on the loan.

The property **remains in the consolidated statement of financial position** at its cost or market value (depending on the accounting policy adopted by Tree). The **loan** of £5 million and **accrued interest** of £300,000 (6 × 50,000) are reported under **non-current liabilities**. Interest of £300,000 is recognised in consolidated profit or loss.

Transaction 2

The key issue is whether Tree **has transferred control** of the branch.

Tree **continues to control the operations** of the branch and the amount that it receives from Vehicle is the operating profit of the branch less the interest payable on the loan. Tree also suffers the effect of any operating losses made by the branch. Therefore, the **position is essentially the same as before** the 'sale' and Tree has not satisfied any performance obligation in return for the consideration of £8 million.

Although Vehicle is not a subsidiary of Tree as defined by IFRS 10, *Consolidated Financial Statements,* it is a special purpose entity (**quasi-subsidiary**). It gives rise to benefits for Tree that are in substance no different from those that would arise if it were a subsidiary. Its assets, liabilities, income and expenses **must be included** in the consolidated financial statements.

The assets and liabilities of Vehicle are included in the consolidated statement of financial position at £7 million (their original value to the group). The loan of £8 million is recognised as a non-current liability. The profit on disposal of £1 million and the operating fee of £1,200,000 are cancelled as intra-group transactions. The operating profit of £2 million is included in consolidated profit or loss, as is the loan interest of £800,000.

6 Taplop

(a) Applying the requirements of IFRS 15 to TrillCo's purchasing pattern at 30 September 20X5, Taplop should conclude that it was highly probable that a significant reversal in the cumulative amount of revenue recognised (£500 per laptop) would not occur when the uncertainty was resolved, that is when the total amount of purchases was known. Consequently, Taplop should recognise revenue of 70 × £500 = £35,000 for the first quarter ended 30 September 20X5.

(b) In the quarter ended 31 December 20X5, TrillCo's purchasing pattern changed such that it would be legitimate for Taplop to conclude that TrillCo's purchases would exceed the threshold for the volume discount in the year to 30 June 20X6, and therefore that it was appropriate to reduce the price to £450 per laptop. Taplop should therefore recognise revenue of £109,000 for the quarter ended 31 December 20X5. The amount is calculated as from £112,500 (250 laptops × £450) less the change in transaction price of £3,500 (70 laptops × £50 price reduction) for the reduction of the price of the laptops sold in the quarter ended 30 September 20X5.

7 Clavering

Sale of hotel complex

The issue here is one of **revenue recognition**, and the accounting treatment is governed by IFRS 15, *Revenue from Contracts with Customers*. Step (5) of the standard's revenue recognition process requires that **revenue is recognised when (or as) a performance obligation is satisfied**. The entity satisfies a performance obligation by transferring **control** of a promised good or service to the customer. A performance obligation can be satisfied **at a point in time**, such as when goods are delivered to the customer, or **over time**. In the case of the hotel transfer, the issue is that of a performance obligation **satisfied at a point in time**. One of the indicators of control is that significant risks and rewards of ownership have been transferred to the customer.

It can be argued in some cases where property is sold that the seller, by continuing to be involved, has **not satisfied the performance obligation by transferring control**, partly because the seller has not transferred the risks and rewards of ownership. In such cases, the **sale is not genuine**, but is often in substance a **financing arrangement**. IFRS 15 requires that the substance of a transaction is determined by looking at the transaction as a whole. If two or more transactions are linked, they should be treated as one transaction to better reflect the commercial substance.

Clavering Leisure continues to operate and manage the hotel complex, receiving the bulk (75%) of the profits, and the residual interest reverts back to Clavering Leisure; effectively, Clavering Leisure **retains control** by retaining the risks and rewards of ownership. Manningtree does not bear substantial risk: its minimum annual income is guaranteed at £15 million. **The sale should not be recognised**. In substance it is a **financing transaction.** The **proceeds** should be treated as a **loan**, and the payment of **profits** as **interest**.

Discount vouchers

The treatment of the vouchers is governed by IFRS 15, *Revenue from Contracts with Customers*. The principles of the standard require the following:

- The voucher should be accounted for as a **separate component** of the sale.
- The promise to provide the discount is a **performance obligation.**
- The entity must estimate the **stand-alone selling price** of the discount voucher in accordance with paragraph B42 of IFRS 15. That estimate must reflect the discount that the customer would obtain when exercising the option, adjusted for both of the following:
  - Any discount that the customer could receive without exercising the option
  - The likelihood that the option will be exercised.

The vouchers are issued as part of the sale of the room and redeemable against future bookings. The substance of the transaction is that **the customer is purchasing both a room and a voucher**.

Vouchers worth £20 million are eligible for discount as at 31 May 20X3. However, based on past experience, it is likely that only one in five vouchers will be redeemed, that is vouchers worth £4 million. Room sales are £300 million, **so effectively, the company has made sales worth £(300m + 4m) = £304 million in exchange for £300 million**. The **stand-alone price would give a total of £300 million for the rooms and £4 million for the vouchers**.

To **allocate the transaction price**, following step (4) of IFRS 15's five-step process for revenue recognition, the proceeds need to be split proportionally **pro rata the stand-alone prices**, that is the discount of £4 million needs to be allocated between the room sales and the vouchers, as follows:

Room sales: 300/304 × £300m = £296.1m Vouchers (balance) = £3.9m

The £3.9 million attributable to the vouchers is only recognised when the performance obligations are fulfilled, that is when the vouchers are redeemed.

8 Rockwye

Matters to consider

The accounting treatment adopted by Rockwye does not appear to comply with IFRS 15 as it appears to be a consignment arrangement in place with retailers. This means that Rockwye cannot recognise any revenue or derecognise inventory when the watches are delivered to retailers because control has not passed from Rockwye to the retailer due to control being retained (the right to fix the price and receive the watches back after 11 months).

Revenue should only be recognised when the retailer makes a sale to a customer. This means that revenue in Rockwye's financial statements is likely to be overstated. In addition, if watches are returned unsold, there may also be a risk that inventory is overstated if any of the watches have suffered any impairment.

Audit procedures

- The auditor should obtain copies of the contracts in place between Rockwye and individual retailers to confirm the supplier arrangements in place and which party retains controls of the watches.
- The auditor should establish the proportion of watches that are returned unsold to determine if there are any indicators of impairment in the inventory held.
- The auditor should re-calculate revenue for a sample of months using the consignment approach and compare to actual revenue recorded to establish if there is any material misstatement.

Chapter 11

Earnings per share

Introduction

Learning outcomes

- Explain and appraise accounting standards that relate to reporting performance: in respect of presentation of financial statements; revenue; operating segments continuing and discontinued operations; EPS; interim reporting
- Determine for a particular scenario what comprises sufficient, appropriate audit evidence
- Design and determine audit procedures in a range of circumstances and scenarios, for example identifying an appropriate mix of tests of controls, analytical procedures and tests of details
- Demonstrate and explain, in the application of audit procedures, how relevant ISAs affect audit risk and the evaluation of audit evidence

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
1	**EPS: overview of material covered in earlier studies** IAS 33, *Earnings per Share* seeks to provide guidance to ensure a consistent basis is followed so that a meaningful comparison can be made over time.	**Approach** This section will be revision from your earlier studies, so should not take long to work through. Do not overlook the brief subsection on auditing EPS. **Stop and think** Why is an adjustment needed for preference shares?	You may be asked for a simple EPS calculation, or more likely re-calculation once a series of adjustments have been made to the SPLOCI. Otherwise you are more likely to get complications that were not tested at Professional Level.	**IQ1: Adjustment for preference shares** This is a straightforward question, revising material from your earlier studies.
2	**Basic EPS: weighted average number of shares** This could be used in practice to compare companies for investment purposes.	**Approach** While you have done the weighted average calculations at Professional Level, you may not have come across all the factors that determine when shares are included in the weighted average.	These topics could come up as part of a financial analysis question.	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
		Stop and think What is the impact of bonus issues, rights issues and share consolidations on EPS?		
3	**Basic EPS: profits attributable to ordinary equity holders** This section focuses on the adjustments to earnings arising as a result of preference shares.	**Approach** Focus on the redeemable versus irredeemable distinction and examples rather than the increasing rate preference shares, which is less likely to come up. **Stop and think** Why does it matter whether the preference shares are redeemable or not?	This area has not yet been examined under the current syllabus.	**IQ2: Redeemable preference shares** This a short, straightforward question to reinforce the main point in this section.
4	**Diluted earnings per share** In addition to basic EPS, IAS 33 requires a diluted figure which takes into account the existence of convertible instruments already issued that could increase the number of shares.	**Approach** This section revises material from your earlier studies before moving on to more difficult topics. **Stop and think** What does 'antidilutive' mean?	Diluted earnings per share is often tested, together with basic EPS, in a question requiring adjustments to financial statements.	N/A
5	**Diluted EPS: convertible instruments** Convertible instruments are one of the most common reasons for dilution.	**Approach** Although this topic won't be entirely new, you may not have considered the indicators that a convertible instrument is antidilutive. **Stop and think** What is the impact of	This is a regular topic for examination and may arise in the context of financial instruments.	**IQ3: Test of dilution** This is a comprehensive question to enable a firm grasp of the dilutive/ antidilutive distinction,

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
		convertibles on EPS?		
6	**Diluted EPS: options** Options are another reason for dilution. Options are dilutive when they are 'in the money'.	**Approach** The key method to take away is: Calculate the number of shares issued at market price. • Find the number of shares issued at nil consideration (the dilutive shares). • Add the dilutive shares to the number of shares under basic EPS. **Stop and think** What is the impact of options on EPS?	Next to convertibles, options are the most common way that the complications of IAS 33 will be tested.	**IQ4: Diluted earnings per share** This is a crucial question as options are new to Advanced Level.
7	**Diluted EPS: contingently issuable shares** These arise in a business combination, where consideration takes the form of shares which will only be issued if certain targets are met in the future. They are also issued to senior staff as a reward for meeting certain targets.	**Approach** Key points to remember: • Do not include the shares in basic EPS unless and until issued. • Include in DEPS only if the conditions have been met. • Include from the beginning of the period or the date of the agreement if later. **Stop and think** What is the impact of contingently issuable shares on EPS?	These are usually tested in the context of performance-based options.	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
8	**Retrospective adjustments, presentation and disclosure** Additional EPS figures are often reported by entities based on what they consider to be sustainable earnings. These are intended to provide a more realistic measure of future performance.	**Approach** Note how IAS 33 interacts with IAS 8 in requiring adjustments adjusted for the effects of errors and those resulting from changes in accounting policies accounted for retrospectively. **Stop and think** Why are additional EPS measures often disclosed?	This topic is most likely to be tested by requiring DEPS for prior periods to be adjusted.	N/A

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 EPS: overview of material covered in earlier studies

Section overview

This section reviews the material on basic and diluted earnings per share covered at Professional Level.

1.1 Scope

IAS 33, *Earnings per Share* applies to entities whose ordinary shares are publicly traded or are in the process of being issued in public markets.

1.2 Basic earnings per share (EPS)

- Basic earnings per share (EPS) is calculated as:

  (Profit/(loss) attributable to ordinary equity holders of the parent) ÷ (Weighted average number of ordinary shares outstanding during the period)
- **Profit attributable to the ordinary equity holders** is based on profit after tax after the deduction of preference dividends and other financing costs in relation to preference shares classified as equity under IAS 32. Whether an adjustment is needed depends on the type of preference share:

Redeemable preference shares	No adjustment is required as these shares are classified as liabilities and the finance charge relating to them will already have been charged to profit or loss as part of finance charges.
Irredeemable preference shares	These shares are classified as equity and the dividend relating to them is disclosed in the statement of changes in equity. This dividend must be deducted from profit for the year to arrive at profit attributable to the ordinary shareholders.

- The **weighted average number of shares** should be adjusted for changes in the number of shares without a corresponding change in resources, for example a bonus issue, by assuming that the new number of shares had always been in issue.

  Shares should generally be included in the weighted average number of shares from the date the consideration for their issue is receivable.
- An entity is required to calculate and present a basic EPS amount based on the profit or loss for the period attributable to the ordinary equity holders of the parent entity. If results from 'continuing operations' and 'discontinued operations' are reported separately, EPS on these results should also be separately reported.

1.3 Diluted earnings per share

- A diluted EPS figure should also be reported by an entity. A dilution is a reduction in the EPS figure (or increase in a loss per share) that will result from the issue of more equity shares on the conversion of convertible instruments already issued.
- For the purpose of calculating diluted earnings per share, an entity shall adjust profit or loss attributable to ordinary equity holders of the parent entity, and the weighted average number of shares outstanding for the effects of all dilutive potential ordinary shares.

1.4 Presentation

- Basic and diluted EPS figures (and from continuing operations if reported separately) should be presented on the face of the statement of comprehensive income with equal prominence.
- Where changes in ordinary shares occur during the accounting period, an amendment is necessary to the number of shares used in the EPS calculations. In some situations, the EPS in prior periods will also have to be adjusted.
- Treasury shares are accounted for as a deduction from shareholders' funds. Since such shares are no longer available in the market, they are excluded from the weighted average number of ordinary shares for the purpose of calculating EPS.

Interactive question 1: Adjustment for preference shares

A company has issued £100,000 4% redeemable non-cumulative preference shares. Should the dividend be subtracted from the reported profit after tax figure for the calculation of EPS?

See **Answer** at the end of this chapter.

1.4.1 Auditing issues

Clearly, the main auditing issues with EPS can be summarised as follows:

- Ensuring that the stated EPS figures comply with IAS 33 (for example, obtaining a breakdown of the amounts and tracing each of them back to their source)
- Ensuring that both basic and diluted EPS figures are presented (so obtaining a copy of the draft financial statements to vouch this)
- Addressing any other disclosure issues as required (for example, treasury shares) by reference to the draft financial statements

2 Basic EPS: weighted average number of shares

Section overview

This section deals with certain adjustments to the number of shares used for the calculation of basic earnings per share.

IAS 33 requires that a time-weighted average number of shares should be used in the denominator of the earnings per share calculation. The basic idea of how to calculate such a weighted average has been covered at Professional Level. In this section we deal with issues relating to the treatment of share repurchases, partly paid shares, bonus and rights issues and the impact of consolidation.

2.1 Calculation of the weighted average number of shares

The use of the weighted average number of ordinary shares outstanding during the period reflects the possibility that the amount of shareholders' capital varied during the period.

The weighted average number of ordinary shares outstanding during the period is the number of ordinary shares outstanding at the beginning of the period, adjusted by the number of ordinary shares bought back or issued during the period multiplied by a time-weighting factor.

2.2 Time weights determination

Shares are usually included in the weighted average number of shares from the date consideration is receivable (which is generally the date of their issue), for example:

- Ordinary shares issued in exchange for cash are included when cash is receivable.
- Ordinary shares issued on the voluntary reinvestment of dividends on ordinary or preference shares are included when dividends are reinvested.
- Ordinary shares issued as a result of the conversion of a debt instrument to ordinary shares are included from the date that interest ceases to accrue.
- Ordinary shares issued in place of interest or principal on other financial instruments are included from the date that interest ceases to accrue.
- Ordinary shares issued in exchange for the settlement of a liability of the entity are included from the settlement date.
- Ordinary shares issued as consideration for the acquisition of an asset other than cash are included as of the date on which the acquisition is recognised.
- Ordinary shares issued for the rendering of services to the entity are included as the services are rendered.
- Ordinary shares issued as part of the cost of a business combination are included in the weighted average number of shares from the acquisition date. This is because the acquirer incorporates into its results the acquiree's profits and losses from that date.
- Ordinary shares that will be issued upon the conversion of a mandatorily convertible instrument are included in the calculation of basic earnings per share from the date the contract is entered into.
- Contingently issuable shares are included in the calculation of basic earnings per share only from the date when all necessary conditions for their issue are satisfied. Shares that are issuable solely after the passage of time are not contingently issuable shares, because the passage of time is a certainty.
- Outstanding ordinary shares that are contingently returnable (ie, subject to recall) are excluded from the calculation of basic earnings per share until the date the shares are no longer subject to recall.

Worked example: Weighted average number of ordinary shares

The following information is provided for an entity.

		Shares issued	Treasury shares	Shares outstanding
1 Jan 20X1	Balance at beginning of year	2,000	300	1,700
31 May 20X1	Issue of new shares for cash	800	–	2,500
1 Dec 20X1	Purchase of treasury shares for cash	–	250	2,250
31 Dec 20X1	Balance at year end	2,800	550	2,250

Requirement

Calculate the weighted average number of shares in issue during the year.

Solution

The calculation can be performed on a cumulative basis:

			Weighted average
1 Jan X1 – 30 May X1	1,700	× 5/12	708
Share issue	800		
31 May X1 – 30 Nov X1	2,500	× 6/12	1,250
Share purchase	(250)		
1 Dec X1 – 31 Dec X1	2,250	× 1/12	188
			2,146

or alternatively each issue or recall treated separately:

			Weighted average
1 Jan X1 – 31 Dec X1	1,700	12/12	1,700
31 May X1 – 31 Dec X1	800	7/12	467
1 Dec X1 – 31 Dec X1	(250)	1/12	(21)
			2,146

2.3 Partly paid shares

Where ordinary shares are issued but not fully paid, they are treated in the calculation of basic earnings per share as a fraction of an ordinary share to the extent that they were entitled to participate in dividends during the period relative to a fully paid ordinary share.

To the extent that partly paid shares are not entitled to participate in dividends during the period they are treated as the equivalent of warrants or options in the calculation of diluted earnings per share. The unpaid balance is assumed to represent proceeds used to purchase ordinary shares. The number of shares included in diluted earnings per share is the difference between the number of shares subscribed and the number of shares assumed to be purchased.

Worked example: Partly paid shares

At 1 January 20X5 an entity had 900 ordinary shares in issue. It issued 600 new shares at 1 September 20X5, at a subscription price of £4 per share. At the date of issue each shareholder paid
£2. The balance of £2 per share will be paid during 20X6. Each part-paid share will be entitled to dividends in proportion to the percentage of the issue price paid up on the share. The entity has a year end of 31 December.

Requirement

Calculate the weighted average number of shares for the year ended 31 December 20X5.

Solution

The new shares issued should be included in the calculation of the weighted average number of shares in proportion to the percentage of the issue price received from the shareholding during the period.

	Shares issued	Fraction of period	Weighted average shares
1 January 20X5 – 31 August 20X5	900	8/12	600
Issue of new shares for cash, part paid (2/4 × 600)	300		
1 September 20X5 – 31 December 20X5	1,200	4/12	400
Weighted average number of shares			1,000

2.4 The impact of bonus issues and share consolidations on the number of shares

The weighted average number of ordinary shares outstanding during the period must be adjusted for events that have changed the number of ordinary shares outstanding without a corresponding change in resources. These include the following:

- Bonus issues (capitalisation issues)
- Share consolidation

2.4.1 Bonus issue

In a bonus or capitalisation issue, or a share split, ordinary shares are issued to existing shareholders for no additional consideration. Therefore, the number of ordinary shares outstanding is increased without a corresponding increase in resources.

The number of ordinary shares outstanding **before** the event is adjusted for the proportionate change in the number of ordinary shares outstanding as if the event had occurred at the beginning of the earliest period presented. For example, on a 2 for 1 bonus issue, the number of ordinary shares outstanding before the issue is multiplied by three to obtain the new total number of ordinary shares, or by two to obtain the number of additional ordinary shares.

Bonus issue after the reporting date

Where a bonus issue takes place after the reporting date but before the financial statements are authorised for issue, the number of shares in the EPS calculation is adjusted for the current and prior periods as though the bonus issue took place during the current year.

Worked example: Bonus issue

The following information is given for an entity.

Profit attributable to ordinary equity holders for y/e 30 September 20X6	£300
Profit attributable to ordinary equity holders for y/e 30 September 20X7	£900
Ordinary shares outstanding until 30 September 20X7	200

Bonus issue 1 October 20X7 – two ordinary shares for each ordinary share outstanding at 30 September 20X7

Requirement

Calculate the basic earnings per share for 20X6 and 20X7.

Solution

The bonus issue arose in the period after the reporting date. It should be treated as if the bonus issue arose during 20X7, and EPS calculated accordingly:

Additional shares issued 200 × 2 = 400 Basic EPS 20X7

£900 ÷ (200 + 400) = £1.50

Basic EPS 20X6

£300 ÷ (200 + 400) = £0.50

2.4.2 Share consolidation

A consolidation of ordinary shares generally reduces the number of ordinary shares outstanding without a corresponding reduction in resources.

Sometimes, however, shares are repurchased at fair value, and in this instance, there is a corresponding reduction in resources. An example is a share consolidation combined with a special dividend. In this case, the weighted average number of ordinary shares outstanding for the period is adjusted for the reduction in the number of ordinary shares from the date the special dividend is recognised.

Worked example: Share consolidation

At the start of its financial year ended 31 December 20X5, an entity had 10 million ordinary shares in issue. On 30 April 20X5 it issued three million shares in consideration for the acquisition of a majority holding in another entity. On 31 August 20X5 it went through a share reconstruction by consolidating the shares in issue, on the basis of one new share for two old shares.

Requirement

Calculate the weighted number of shares in issue for the year to 31 December 20X5.

Solution

The three million new shares issued at the time of the acquisition should be weighted from the date of issue, but the consolidation should be related back to the start of the financial year (and to the start of any previous years presented as comparative figures).

The calculation of the weighted number of shares in issue is as follows:

Number			**Weighting**
At 1 January 20X5			10,000,000
Effect of consolidation is to halve the number of shares (since one new share was issued for every two old			
Adjusted number			
shares held)	(5,000,000)		
	5,000,000	12/12	5,000,000
30 April 20X5 issue	3,000,000		
Effect of consolidation is to halve the number of shares	(1,500,000)		
	1,500,000	8/12	1,000,000
Weighted average shares in issue			6,000,000

CHAPTER 11

Worked example: Special dividend and share consolidation

A company has issued 20,000 shares with a nominal value of 20p each. At the beginning of 20X7 it considers whether to launch a share repurchase of 2,000 shares at the current market price of £2 per share, or pay a special dividend of 20p per share to be followed by a share consolidation of 9 new shares for 10 old shares. The profit after tax for 20X6 and 20X7 is expected to be £4,000 for each year. Interest rates stand at 5% and the company tax rate is 20%.

Requirement

Calculate the basic EPS for the two alternatives.

Solution Basic EPS

(1) **Share repurchase at fair value**

	20X7	**20X6**
	£	**£**
Profit for the year	4,000	4,000
Loss of interest as cash		
paid out £4,000 × 0.05 × 0.80*	(160)	
Earnings	3,840	4,000
Number of shares outstanding	18,000	20,000
Earnings per share	21.33p	20.00p

(2) **Special dividend followed by share consolidation**

	20X7	**20X6**
	£	**£**
Profit for the year	4,000	4,000
Loss of interest on cash paid out as dividend		
£4,000 × 0.05 × 0.80*	(160)	
Earnings	3,840	4,000

The effect of share consolidation is to leave the total nominal value of outstanding shares the same, but to reduce the number of shares from 20,000 to 18,000, and raising the market price of a share from £2 to £2.22.

	20X7	**20X6**
Number of shares	18,000	20,000
Earnings per share	21.33p	20.00p

No adjustment to prior year's EPS is made for the share consolidation.

* 0.80 = (1 – tax rate)

2.5 Rights issue

A rights issue is an issue of shares for cash to the existing ordinary equity holders in proportion to their current shareholdings, at a discount to the current market price.

Because the issue price is below the market price, a rights issue is in effect a combination of **an issue at fair value and a bonus issue.**

In order to calculate the weighted average number of shares when there has been a rights issue, an adjustment factor is required:

Adjustment factor = Pre-rights issue price of shares ÷ Theoretical ex-rights price (TERP)

The TERP is the theoretical price at which the shares would trade after the rights issue and takes into account the diluting effect of the bonus element in the rights issue. It is calculated as:

TERP = (Total market value of original shares pre-rights issue + Proceeds of rights issue) ÷ Number of shares post rights issue

The adjustment factor is used to increase the number of shares in issue **before** the rights issue for the bonus element.

Where the rights are to be publicly traded separately from the shares before the exercise date, fair value for the purposes of this calculation is established at the close of the last day on which the shares are traded together with the rights.

Worked example: Rights issue

The following information is provided for an entity which is making a rights issue.

	20X4	**20X5**	**20X6**
Profit attributable to ordinary equity holders of the parent entity	£1,100	£1,500	£1,800

Shares outstanding before rights issue: 500 shares

Rights issue: One new share for each five outstanding shares (100 new shares total) Exercise

price: £5.00

Date of rights issue: 1 January 20X5

Last date to exercise rights: 1 March 20X5

Market price of one ordinary share immediately before exercise on 1 March 20X5: £11.00

Reporting date 31 December

Requirement

Calculate the theoretical ex-rights value per share and the basic EPS for each of the years 20X4, 20X5 and 20X6.

Solution

Calculation of theoretical ex-rights value per share

	No.	**Price**	**Total**
Pre-rights issue holding	5	£11	£55
Rights share	1	£5	£5
	6		£60

Therefore TERP = £60/6 = £10

(The TERP may also be calculated on the basis of all shares in issue ie, £6,000/600 shares.)

Calculation of adjustment factor

Adjustment factor = Fair value share before exercise of rights ÷ Theoretical ex-rights value per share

CHAPTER 11

Calculation of basic earnings per share 20X4

20X4 basic EPS as originally reported: £1,100 ÷ 500 shares =	£2.20
20X4 basic EPS restated for rights issue in 20X5 accounts: £1,000 ÷ (500 shares) × (adjustment factor) = £2.00	

Alternatively the restated EPS may be calculated by applying the reciprocal of the adjustment factor to the basic EPS as originally reported:

£2.20 × 10/11 = £2.00

20X5

Weighted average number of shares:

1 January – 28 February	500 × 11/10	× 2/12	92	
Rights issue	100			
1 March – 31 December	600	× 10/12	500	592

Basic EPS including effects of rights issue: £1,500 ÷ 592 shares = £2.53

20X6

Basic EPS: £1,800 ÷ 600 shares = £3.00

Worked example: Cash and rights issue

An entity had 14 million ordinary shares in issue on 1 January 20X4 and 20X5. In its financial year ended 31 December 20X5 it issued further shares, as follows:

- On 1 April 20X5, 4 million shares in consideration for the majority holding in another entity.
- On 1 July 20X5 a rights issue of 1 for 6 at £15 when the market price of the existing shares was £20. There were 18 million shares in issue at this date, another 3 million shares were therefore issued.

A profit of £17 million attributable to the ordinary equity holders was reported for 20X5 and £14 million for 20X4.

Requirement

Calculate the earnings per share for 20X5 and restate the comparative for 20X4.

Solution

As the shares issued on the acquisition were issued at full fair value, a time apportionment adjustment over the period they are in issue is required.

The rights issue shares require a time apportionment adjustment and an adjustment for the bonus element in the rights. The latter adjustment should be applied to the shares issued on 1 April as well as to those issued earlier.

To adjust for the bonus element the theoretical ex-rights fair value per share is required:

Computation of theoretical ex-rights price (TERP):

	No.	Price	Total
Pre-rights issue holding	6	£20	£120
Rights share	1	£15	£15
	7		£135

Therefore TERP = £135/7 = £19.29

The adjustment factor is therefore £20/£19.29

20X4 and earlier EPS figures would be adjusted by dividing the corresponding earnings figure by 1.037.

The weighted number of shares in issue in 20X5 is calculated as:

	Number	Weighting	Adjusted number
1 January to 31 March	14,000,000 × 20/19.29	3/12	3,628,823
Issue 1 April	4,000,000		
1 April to 30 June	18,000,000 × 20/19.29	3/12	4,665,630
Rights issue 1 July	3,000,000		
1 July to 31 December	21,000,000	6/12	10,500,000
Weighted average shares in issue			18,794,453

20X5 EPS:

£17m/18,794,453 shares = £0.90

20X4 restatement – original EPS: £14m ÷ 14m shares = £1.00

£1.00 × 19.29/20.00 = £0.96

3 Basic EPS: profits attributable to ordinary equity holders

Section overview

In this section we discuss the adjustments that are required to earnings as a result of preference shares, in order to calculate profits attributable to ordinary shareholders (equity holders).

As we have seen in earlier studies, for the purpose of calculating basic earnings per share, we must calculate the amounts attributable to ordinary equity holders of the parent entity in respect of profit or loss.

This is done in two steps:

- First the profit or loss which includes all items of income and expense that are recognised in a period, including tax expense, dividends on preference shares classified as liabilities or non-controlling interest is calculated according to IAS 1, *Presentation of Financial Statements*.

- In the second step the calculated profit or loss is adjusted for the after-tax amounts of preference dividends, differences arising on the settlement of preference shares, and other similar effects of preference shares classified as **equity** under IAS 32, *Financial Instruments: Presentation*.

3.1 Adjusting earnings for the impact of preference shares

Where an entity has preference shares in issue depending on their terms these will be classified under IAS 32 as either:

- **financial liabilities**; or
- **equity.**

3.1.1 Preference shares classified as equity

Any dividends and other appropriations (for example, amortised premium or discount) is debited directly to equity, in the statement of changes in equity. Therefore an adjustment is required to deduct these amounts from the profit for the period in order to derive the profit attributable to ordinary shareholders (equity holders).

3.1.2 Preference shares classified as liabilities

Any dividends or other appropriations are treated as finance costs in arriving at profit for the period and no adjustment is required.

In both the above cases the treatment is the same, as in both cases the amounts are deducted from profit attributable to ordinary shareholders. In the latter case the deduction will already have been made in arriving at reported profit and loss, however in the former case an adjustment to reported profits is required.

3.1.3 Cumulative preference shares

Where preference shares are **cumulative**, the dividends for the period need to be taken into account irrespective of whether these have been declared or not.

3.1.4 Non-cumulative preference shares

For non-cumulative preference dividends only the amount of dividend declared for the period should be deducted in arriving at profit or loss attributed to ordinary equity holders.

Interactive question 2: Redeemable preference shares

Turaco is a company listed on a recognised stock exchange. Given below is an extract from its statement of comprehensive income for the year ended 31 December 20X6.

	£
Profit before tax	500,000
Tax	150,000
Profit after tax	350,000

The company paid an ordinary dividend of £20,000 and a dividend on its redeemable preference shares of £70,000.

The company had £100,000 of £0.50 ordinary shares in issue throughout the year and authorised share capital of 1,000,000 ordinary shares.

Requirement

What is the basic earnings per share figure for the year according to IAS 33, *Earnings per Share*?

See **Answer** at the end of this chapter.

3.1.5 Other adjustments in respect of preference shares Increasing rate preference shares

These are preference shares that provide for a low initial dividend to compensate an entity for selling the preference shares at a discount, or an above-market dividend in later periods to compensate investors for purchasing preference shares at a premium.

Under IAS 32, *Financial Instruments: Presentation* and IFRS 9, *Financial Instruments* any original issue discount or premium on increasing rate preference shares is amortised using the effective interest method and treated as a preference dividend for the purposes of calculating earnings per share.

In addition, there may be other elements amortised such as transaction costs.

All these elements should be deducted in arriving at the earnings attributed to ordinary equity holders.

Worked example: Increasing rate preference shares

Dennison Co issued non-convertible, non-redeemable class A cumulative preference shares of £100 par value on 1 January 20X1. The class A preference shares are entitled to a cumulative annual dividend of £7 per share starting in 20X4.

At the time of issue, the market rate dividend yield on the class A preference shares was 7% a year. Thus, Dennison Co could have expected to receive proceeds of approximately £100 per class A preference share if the dividend rate of £7 per share had been in effect at the date of issue.

There was, however, to be no dividend paid for the first three years after issue. In consideration of these dividend payment terms, the class A preference shares were issued at £81.63 per share ie, at a discount of £18.37 per share. The issue price can be calculated by taking the present value of £100, discounted at 7% over a three-year period.

Requirement

Calculate the imputed dividends attributable to preference shares that need to be deducted from earnings to determine the profit or loss attributable to ordinary equity holders.

Solution

Because the shares are classified as equity, the original issue discount is amortised to retained earnings using the effective interest method and treated as a preference dividend for earnings per share purposes. To calculate basic earnings per share, the following imputed dividend per class A preference share is deducted to determine the profit or loss attributable to ordinary equity holders of the parent entity.

Year	Carrying amount of class A preference shares 1 Jan £	Imputed dividend £	Carrying amount of class A preference shares 31 Dec £	Dividend paid £
20X1	81.63	5.71	87.34	–
20X2	87.34	6.12	93.46	–
20X3	93.46	6.54	100.00	–
Thereafter	100.00	7.00	107.00	(7.00)

CHAPTER 11

Convertible preference shares

An entity may achieve early conversion of convertible preference shares by improving the original conversion terms or paying additional consideration.

- Where this is the case, then the excess amount transferred as a result of the improvement of conversion terms is treated as a return to the preference shareholders and so should be deducted in arriving at earnings attributable to ordinary equity holders.

Deduction	=	Fair value of ordinary shares issued/consideration paid	–	Fair value of ordinary shares issuable under original terms

Worked example: Cumulative convertible preference shares

An entity issued £100,000 2% cumulative convertible preference shares in 20X4 and the shares were due to be converted in the current year, 20X6.

The convertible shares were converted at the beginning of 20X6 and no dividend was accrued in respect of the year, although the previous year's dividend was paid immediately before conversion. The terms of conversion were also amended and the revised terms entitled the preference shareholders to a total additional 100 ordinary shares on conversion with a fair value of £300.

Requirement

If the profit attributable to ordinary equity holders for the year is £150,000 what adjustments need to be made for the purpose of calculating EPS in 20X6?

Solution

The excess of the fair value of additional ordinary shares issued on conversion of the convertible preference shares over fair values of the ordinary shares to which they would have been entitled under the original conversion terms is deducted from profit as it is an additional return to the convertible preference shareholders.

	£
Profits attributable to the ordinary equity holders	150,000
Fair value of additional ordinary shares issued on conversion of convertible preference shares	(300)
	149,700

There is no adjustment in respect of the preference shares as no dividend accrual was made in respect of the year. The payment of the previous year's cumulative dividend is ignored for EPS purposes as it will have been adjusted for in the prior year.

Repurchase of preference shares

- Where the fair value of consideration paid to preference shareholders exceeds the carrying value of the preference shares repurchased, the excess is a return to the preference shareholders and must be deducted in calculating profits attributable to ordinary equity holders.
- Where the carrying value of preference shares repurchased exceeds the fair value of consideration paid, the excess is added in calculating profit attributable to ordinary equity holders.

In respect of preference shares that are classified as liabilities, the above adjustments, where these are relevant, would have already been made in arriving at the profit or loss for the period.

Worked example: Repurchase of preference shares

An entity has issued £100,000 8% non-redeemable non-cumulative preference shares. Half way through the year, the entity repurchased half of the preference shares at a discount of £1,000. No dividends were paid on these shares in respect of the amounts repurchased or outstanding at the end of the year.

Requirement

If the profit attributable to ordinary equity holders for the year is £150,000, what adjustments should be made for the purpose of calculating EPS?

Solution Adjustments

	£
Profit for the year attributed to ordinary equity holders	150,000
Plus discount on repurchasing of preference shares	1,000
	151,000

The discount on repurchase of the preference shares has been credited to equity and it must therefore be adjusted against profit.

Had there been a premium payable on repurchase, the loss on repurchase would have been subtracted from profit.

No accrual for the dividend on the 8% preference shares is required as these are non-cumulative. Had a dividend been paid for the year it would have been deducted from profit for the purpose of calculating basic EPS as the shares are treated as equity and the dividend would have been charged to equity in the financial statements.

3.2 Participating securities and two-class ordinary shares

The equity of some entities includes:

- instruments that participate in dividends with ordinary shares according to a predetermined formula (for example, 2 for 1) with an upper limit on the extent of participation (for example, up to, but not beyond, a specified amount per share); or
- a class of ordinary shares with a different dividend rate from that of another class of ordinary shares.

Profit or loss for the period is allocated to the different classes of shares and participating equity instruments in accordance with their dividend rights or other rights to participate in undistributed earnings.

To calculate basic earnings per share:

- Profit or loss attributable to ordinary equity holders of the parent entity is adjusted as previously discussed.
- The remaining profit or loss is allocated to ordinary shares and participating equity instruments to the extent that each instrument shares in earnings as if all of the profit or loss for the period had been distributed. The total profit or loss allocated to each class of equity instrument is determined by adding together the amount allocated for dividends and the amount allocated for a participation feature.

- The total amount of profit or loss allocated to each class of equity instrument is divided by the number of outstanding instruments to which the earnings are allocated to determine the earnings per share for the instrument.

Worked example: Participating equity instruments

The following information is provided for an entity.

Profit attributable to equity holders of the parent entity	£100,000
Ordinary shares outstanding	10,000
Non-convertible preference shares	6,000
Non-cumulative annual dividend on preference shares	
(before any dividend is paid on ordinary shares)	£5.50 per share

After ordinary shares have been paid at a dividend of £2.10 per share, the preference shares participate in any additional dividends on a 20:80 ratio with ordinary shares.

Dividends on preference shares paid – £33,000 (£5.50 per share × 6,000 shares)

Dividends on ordinary shares paid – £21,000 (£2.10 per share × 10,000 shares)

Requirement

Calculate the earnings attributable to ordinary shares.

Solution

Basic earnings per share is calculated as follows

	£	£
Profit attributable to equity holders of the parent entity 100,000 Less dividends paid:		
Preference		33,000
Ordinary		21,000
		(54,000)
Undistributed earnings		46,000

Allocation of undistributed earnings

Let A be the allocation of undistributed earnings per ordinary share and B the allocation per preference share. That is:

(A × 10,000) + (B × 6,000) = £46,000

As B's entitlement is one quarter that of A's, we can eliminate B from the equation as follows:

(A × 10,000) + (1/4 × A × 6,000) = £46,000

10,000A + 1,500A = £46,000

11,500A = £46,000 A = £46,000/11,500 A = £4.00

Therefore B = £1.00

Basic per share amounts Basic per share amounts

	Per preference share	Per ordinary share
Distributed earnings	£5.50	£2.10
Undistributed earnings	£1.00	£4.00
Totals	£6.50	£6.10

Professional skills focus: Assimilating and using information

As we have seen, although the basic EPS calculation is straightforward, a great deal of information needs to be assimilated and understood, both regarding earnings (adjustments for preference shares) and weighted average number of shares (changes in share capital). The two interact.

4 Diluted earnings per share

Section overview

This section deals with the adjustments required to earnings in order to take into account the dilutive impact of potential ordinary shares.

The objective of diluted earnings per share is consistent with that of basic earnings per share; that is, to provide a measure of the interest of each ordinary share in the performance of an entity taking into account **dilutive** potential ordinary shares outstanding during the period.

4.1 Potential ordinary shares

Potential ordinary shares are financial instruments or other contracts that may entitle their holders to ordinary shares. Potential ordinary shares are as follows:

- Various financial liabilities or equity instruments, including preference shares that are convertible into ordinary shares
- Options
- Warrants
- Shares that would be issued on satisfaction of certain conditions that result from contractual arrangements, such as the purchase of a business or other assets

The conversion of potential ordinary shares will lead in the future to an increase in the weighted average number of ordinary shares outstanding by the weighted average number of additional ordinary shares that would have been outstanding assuming the conversion of all dilutive potential ordinary shares.

Conversion may also lead to consequential changes in income or expenses. For example, the reduction of interest expense related to convertible debt and the resulting increase in profit or reduction in loss may lead to an increase in the expense related to a non-discretionary employee profit-sharing plan.

For the purpose of calculating diluted earnings per share, profit or loss attributable to ordinary equity holders of the parent entity is adjusted for any such consequential changes in income or expense.

4.2 Dilutive and antidilutive potential ordinary shares

Potential ordinary shares are **dilutive** when their conversion to ordinary shares would decrease earnings per share or increase loss per share from continuing operations.

Potential ordinary shares are **antidilutive** when their conversion to ordinary shares would increase earnings per share or decrease loss per share from continuing operations. **Antidilution** is therefore the situation where the 'diluted' EPS is greater than the basic EPS (or where there is a lower loss per share). IAS 33 defines antidilution as follows.

Definition

Antidilution: An increase in earnings per share or a reduction in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

In computing diluted EPS only potential ordinary shares that are dilutive are considered in the calculations. The calculation ignores the effects of potential ordinary shares that would have an antidilutive effect on earnings per share.

Determining whether potential ordinary shares are dilutive or antidilutive

In determining whether potential ordinary shares are dilutive or antidilutive, **each issue or series of potential ordinary shares is considered separately rather than in aggregate.**

A separate EPS calculation is performed for each potential share issue.

(a) Those individual EPS which exceed the entity's basic EPS are disregarded as they are antidilutive.

(b) Those individual EPS which are less than the entity's basic EPS are dilutive and are ranked from most to least dilutive. Options and warrants are generally included first because they do not affect the numerator of the calculation. These dilutive factors are added one by one into the DEPS calculation in order to identify the maximum dilution.

The calculation showing each issue or series of potential ordinary shares being considered separately is shown in the worked example Convertible loan stock 2.

4.3 Computation of diluted earnings

For the purpose of calculating diluted earnings per share, the profit or loss attributable to ordinary equity holders of the parent entity should be adjusted for the after-tax effect of:

- any dividends or other items related to dilutive potential ordinary shares deducted in arriving at profit or loss attributable to ordinary equity holders;
- any interest recognised in the period related to dilutive potential ordinary shares; and
- any other changes in income or expense that would result from the conversion of the dilutive potential ordinary shares.

After the potential ordinary shares are converted into ordinary shares, the dividends, interest and any other expenses associated with the potential ordinary shares will no longer arise. Instead, the new ordinary shares are entitled to participate in profit or loss attributable to ordinary equity holders of the parent entity. The expenses associated with potential ordinary shares include transaction costs and discounts accounted for in accordance with the effective interest method.

4.4 Calculation of the number of shares

In the calculation of diluted earnings per share, the number of ordinary shares in the denominator is the weighted average number of ordinary shares calculated for the basic earnings per share plus the weighted average number of ordinary shares that would be issued on the conversion of all the dilutive potential ordinary shares into ordinary shares. That is:

Number of shares in diluted earnings per share	=	Number of shares in basic earnings per share	+	Dilutive potential ordinary shares

- Dilutive potential ordinary shares shall be deemed to have been converted into ordinary shares at the **beginning of the period** or, if later, the **date of the issue** of the potential ordinary shares (ie, where the convertible instruments or options are issued during the current period).
- Potential ordinary shares are weighted for the period they are outstanding.
- Potential ordinary shares that are cancelled or allowed to lapse during the period are included in the calculation of diluted earnings per share only for the portion of the period during which they are outstanding.
- Potential ordinary shares that are converted into ordinary shares during the period are included in the calculation of diluted earnings per share from the beginning of the period to the date of conversion. From the date of conversion, the resulting ordinary shares are included in both basic and diluted earnings per share.
- The number of ordinary shares that would be issued on conversion of dilutive potential ordinary shares is determined from the terms of the potential ordinary shares. When more than one basis of conversion exists, the calculation assumes the **most advantageous** conversion rate or exercise price from the standpoint of the holder of the potential ordinary shares.

5 Diluted earnings per share: convertible instruments

Section overview

This section deals with the impact of convertible instruments on the diluted earnings per share.

5.1 Convertible instruments

Convertible instruments, such as convertible loan stock or convertible preference shares impact both the profit or loss attributed to ordinary equity holders, and the number of ordinary shares, on conversion.

Where this has a dilutive effect, the instrument should be taken into account when calculating diluted earnings per share (DEPS).

Indicators that convertible instruments are antidilutive

Convertible preference shares are antidilutive whenever the amount of the dividend on such shares declared in, or accumulated for, the current period per ordinary share obtainable on conversion exceeds basic earnings per share.

Similarly, convertible debt is antidilutive whenever its interest (net of tax and other changes in income or expense) per ordinary share obtainable on conversion exceeds basic earnings per share.

Worked example: Convertible loan stock 1

On 1 January 20X5 entity A had in issue:

- 24 million ordinary shares of £1 nominal value each; and
- £8 million of 8% convertible loan stock. These were issued on 1 January 20X5 and are convertible at any time from 1 January 20X8. The conversion terms are one ordinary share for each £2 nominal of loan stock.

The split accounting required for compound financial instruments per IAS 32 resulted in a liability element for the loan stock of £7 million and an effective interest rate of 10%.

After charging income tax at 20%, the entity reported profit attributable to the ordinary equity holders of £15 million for its year ended 31 December 20X5.

Requirement

Calculate the basic and diluted earnings per share for 20X5.

Solution Basic EPS
£15m/24m shares = £0.63

Diluted EPS

To calculate the diluted earnings per share we need to consider the impact on both earnings and number of shares.

Impact on earnings:	On conversion, after tax earnings attributed to ordinary shareholders should be increased by the reduction in the interest charge payable to loan holders. Taking tax into account, the interest saved will be: £7m × 0.1 × (1 – 0.2) = £0.56m Therefore diluted earnings = £15m + £0.56m = £15.56m
Impact on number of shares:	On conversion the number of ordinary shares will increase by £8m/2 = 4 million shares, raising the number of ordinary shares after conversion to 28 million ordinary shares.

Therefore DEPS = £15.56m/28 million shares = £0.56

Professional skills focus: Structuring problems and solutions

The approach to calculating diluted EPS requires skills at structuring the problem. First basic EPS needs to be calculated. Then the profit or loss attributable to ordinary equity holders of the parent entity needs to be adjusted for dividends, interest or relating to the dilutive potential of any other changes in income or expense that would result from the conversion of the dilutive potential ordinary shares. Then the basic EPS denominator needs to be adjusted for the weighted average number of ordinary shares that would be issued on the conversion of all the dilutive potential ordinary shares into ordinary shares.

Interactive question 3: Test of dilution

The issued share capital of Entity A at 31 December 20X5 was 2,000,000 ordinary shares of £1 each. On 1 January 20X6, Entity A issued £1,500,000 of 7% convertible loan stock for cash at par. (Ignore the requirement to split the value of a compound financial instrument.) Each £100 nominal of the loan stock may be converted into 140 ordinary shares at any time after 1 January 20X9.

The profit before interest and taxation for the year ended 31 December 20X6 amounted to £1,050,000 and arose exclusively from continuing operations. The rate of tax is 30%.

Requirement

Test whether the potential shares are dilutive.

See **Answer** at the end of this chapter.

Worked example: Convertible loan stock 2

On 1 January 20X5 Entity A had in issue:

(1) 20 million ordinary shares;

(2) £11 million of 6.5% convertible loan stock, convertible at any time from 1 January 20X7. The conversion terms are one ordinary share for each £2 nominal of loan stock, the 1 January carrying amount of the liability component is £10 million and the effective interest rate is 9%;

(3) £9 million of 6.75% convertible loan stock, convertible at any time from 1 January 20X8. The conversion terms are one ordinary share for each £2 nominal of loan stock, the 1 January carrying amount of the liability component is £8 million and the effective interest rate is 8%; and

(4) £12.6 million of 9% convertible loan stock, convertible at any time from 1 January 20X9. The conversion terms are one ordinary share for each £6 nominal of loan stock, the 1 January carrying amount of the liability component is £12 million and the effective interest rate is 12%.

The entity reported profit attributable to the ordinary equity holders of £4 million for its year ended 31 December 20X5.

Requirement

Ignoring taxes, calculate the diluted earnings per share.

Solution

The incremental earnings per share for each type of potential ordinary shares is shown below.

	Increase in earnings (interest saved) £	Increase in number of shares	Earnings per additional share £
£11 million of 6.5% convertible loan stock			
£10m × 9% convertible loan stock	900,000		
1 ordinary share for £2 nominal of loan stock		5,500,000	0.16
£9 million of 6.75% convertible loan stock			
£8m × 8% convertible loan stock	640,000		
1 ordinary share for £2 nominal of loan stock		4,500,000	0.14
£12.6 million of 9% convertible loan stock			
£12m × 12% convertible loan stock	1,440,000		
1 ordinary share for £6 nominal of loan stock		2,100,000	0.69

The earnings per share can be calculated adjusting both the earnings and the number of shares for each type of potential shares, and the results are shown below. Each issue of potential ordinary shares is added to the calculation at a time, taking the most dilutive factor first.

	Earnings	Number of shares	Earnings per share
	£		£
Shares already in issue	4,000,000	20,000,000	0.20
Including 6.75% convertible loan stock	4,640,000	24,500,000	0.189
Including 6.5% convertible loan stock	5,540,000	30,000,000	0.185
Including 9% convertible loan stock	6,980,000	32,100,000	0.217

The diluted earnings per share will be £0.185. The 9% convertible loan stock is antidilutive since it increases earnings per share, and it will not be taken into account in calculating diluted earnings per share.

Professional skills focus: Assimilating and using information

The above example is a good illustration of the skill of assimilating information (the position at the start, the effect on both earnings and number of shares of each type of potential shares), as well as the skill of using this information by presenting each effect in a logical layout in order to arrive at the resulting diluted earnings per share figure.

5.2 Testing for dilution

In some cases some convertible preference shares are redeemed or converted in a period, and others remain outstanding.

Where this occurs, any excess consideration paid on redemption or conversion is attributed to those shares which have been redeemed or converted.

Outstanding convertible preference shares are therefore tested for dilution as normal and without regard to this excess.

6 Diluted EPS and options

Section overview

This section deals with the impact of options on diluted earnings per share.

Definition

Options and warrants: Financial instruments that give the holder the right to purchase ordinary shares.

6.1 Options, warrants and their equivalents

Options and warrants are dilutive when they would result in the issue of ordinary shares for less than the average market price of ordinary shares during the period (ie, when they are 'in the money').

To calculate diluted EPS where there are options or warrants, the potential ordinary shares at less than average market price are treated as consisting of two elements:

- A contract to issue some shares at **average market price**. These shares are assumed to be fairly priced and to be neither dilutive nor antidilutive. They are ignored in the calculation of diluted EPS.
- A contract to issue the remaining ordinary shares for **no consideration.** These shares are dilutive and are added to the number of ordinary shares outstanding in the calculation of diluted EPS.

Average market price of ordinary shares

- Theoretically every market transaction for an entity's ordinary shares could be included in the determination of the average market price. It is however adequate to use a simple average of weekly or monthly prices.
- Generally, closing market prices are adequate for calculating the average market price. When prices fluctuate widely, however, an average of the high and low prices usually produces a more representative price.
- The method used to calculate the average market price must be used consistently unless it is no longer representative because of changed conditions. For example, an entity that uses closing market prices to calculate the average market price for several years of relatively stable prices might change to an average of high and low prices if prices start fluctuating greatly and the closing market prices no longer produce a representative average price.

Interactive question 4: Diluted earnings per share

At 31 December 20X6, the issued share capital of Entity A consisted of 3,000,000 ordinary shares of 20p each. Entity A has granted options that give holders the right to subscribe for ordinary shares between 20X8 and 20X9 at 50p each. Options outstanding at 31 December 20X7 were 600,000.
There were no grants, exercises or lapses of options during the year. The profit after tax attributable to ordinary equity holders for the year ended 31 December 20X7 amounted to £900,000 arising from continuing operations. The average market price of one ordinary share during year 20X7 was
£1.50.

Requirement

Calculate the diluted earnings per share for 20X7.

See **Answer** at the end of this chapter.

6.2 Employee share options

The most common type of option that leads to earnings dilution is an employee share option granted by a company to its employees.

Employee share options give the right to the holder to acquire shares in the company at a price that is fixed when the options are issued.

Employee share options can normally be exercised after a certain time eg, once the employee has completed a period of service and within a certain period eg, over a period of five years after they become exercisable.

Employee share options that can be exercised are **vested** options, whereas options that cannot yet be exercised are **unvested** options.

Worked example: Vested options

The profit attributable to the ordinary equity holders of an entity for the year ended 31 December 20X5 was £30 million and the weighted average number of its ordinary shares in issue was 60 million. Its basic earnings per share was £0.50.

In addition, there was a weighted average of five million shares under options which had vested (ie, were able to be exercised). The exercise price for the options was £21 and the average market price per share over the year was £30.

Requirement

Calculate the diluted EPS.

Solution

The amount to be received on exercise is £21 × 5m = £105m

The number of shares issued at average market price is: £105m / £30 = 3.5m

The number of 'free' shares is: 5 million issued – 3.5 million issued at average market price = 1.5 million

Diluted earnings per share:

£30m/(60m + 1.5m) = £0.49

Where shares are **unvested**, the amount still to be recognised in profit or loss before the vesting date must be taken into account when calculating the number of 'free' shares.

Worked example: Unvested options

Assume the same information as in above example, except that:

- the options have not yet vested; and
- the amount to be recognised in relation to these options in the entity's profit or loss over future accounting periods up to date of vesting, as calculated according to IFRS 2, is £15 million.

Requirement

Calculate the diluted EPS.

Solution

The amount to be recognised in profit or loss is reduced to a per share amount: £15m/5m =

£3 This is added to the exercise price: £21 + £3 = £24

The amount to be received on exercise: £24 × 5m = £120m

The number of shares issued at average market price: £120m/£30 = 4m The number of 'free'

shares: 5m – 4m = 1m

Diluted earnings per share: £30m/(60m + 1m) = £0.49

7 Diluted EPS: contingently issuable shares

Section overview

This section deals with the impact of contingently issuable shares on the number of ordinary shares used in the calculation of diluted earnings per share.

7.1 Contingently issuable shares

The consideration for acquisitions of other entities may partly be in the form of shares which will only be issued if certain targets are met in the future. The additional consideration is contingent consideration and the additional shares are described as contingently issuable.

Contingently issuable shares may also arise where senior staff members are issued shares as a performance reward.

- Until the shares are issued (if indeed they ever are), they should not be taken into account when calculating basic EPS.
- They should be taken into account when calculating diluted EPS **if and only if** the conditions leading to their issue have been satisfied. For these purposes the end of the accounting period is treated as the end of the contingency period.
- Contingently issuable shares are included from the beginning of the period (or from the date of the contingent share agreement, if later).

Worked example: Contingently issuable shares

The profit attributable to the ordinary equity holders of an entity for the year ended 31 December 20X5 was £20 million and the weighted average number of its ordinary shares in issue was 16 million. Basic earnings per share was therefore £1.25.

Under an agreement relating to a business combination, two million additional shares were to be issued if the share price on 30 June 20X6 was £8 or above. On 31 December 20X5 the share price was £9. Assuming the end of the reporting period was the end of the contingency period, the condition would have been met.

Requirement

Determine the diluted EPS.

Solution

As the two million additional shares do not result in additional resources for the entity, they are brought into the diluted earnings per share calculation from the start of the 20X5 reporting period. The diluted earnings per share is therefore:

Diluted earnings per share = £20m/(16m + 2m) = £1.11

7.2 Conditions for issue

Contingently issuable shares are included within the calculation of diluted EPS where:

- the shares have not yet been issued
- the relevant performance criteria have been met

Future earnings

Achieving or maintaining a specified level of earnings for a particular period may be the condition for contingent issue.

In this case, if the effect is dilutive, the calculation of diluted EPS is based on the number of ordinary shares that would be issued if the amount of earnings at the end of the reporting period were the amount of earnings at the end of the contingency period.

Market price of shares

The number of ordinary shares contingently issuable may depend on the future market price of the ordinary shares.

In this case, if the effect is dilutive, the calculation of diluted EPS is based on the number of ordinary shares that would be issued if the market price at the end of the reporting period were the market price at the end of the contingency period.

If the condition is based on an average of market prices over a period of time that extends beyond the end of the reporting period, the average for the period of time that has lapsed is used.

Future earnings and market price of shares

The number of ordinary shares contingently issuable may depend on future earnings and future prices of the ordinary shares.

In such cases, the number of ordinary shares included in the diluted EPS calculation is based on both conditions (ie, earnings to date and the current market price at the end of the reporting period).

Contingently issuable ordinary shares are not included in the diluted earnings per share calculation unless both conditions are met

Other conditions

In other cases, the number of ordinary shares contingently issuable may depend on a condition other than earnings or market price (for example, the opening of a specific number of retail stores).

In this case, the contingently issuable ordinary shares are included in the calculation of diluted earnings per share according to the status at the end of the reporting period

Cumulative targets

Note that where performance criteria involve a cumulative target, no dilution is accounted for until the cumulative target has been met. For example, where the issue of shares is dependent upon average profits of £300,000 over four years, the cumulative target is £1,200,000. No dilution is accounted for until this cumulative target is met.

Worked example: Cumulative targets

A manufacturer has in issue 3,000,000 ordinary shares at 1 January 20X7. It agreed to issue 500,000 shares to its staff if factory output averages 100,000 units per annum over the period from 1 January 20X7 to 31 December 20X9. The shares are to be issued on 1 January 20Y0.

Results for the three periods are:

	Units produced	Profits
20X7	120,000	£780,000
20X8	99,000	£655,000
20X9	105,000	£745,000

Requirement

What are basic and diluted EPS in each of the years 20X7–20X9?

Solution

The cumulative target of 3 years × 100,000 units is not met in 20X7 and 20X8, therefore no dilution is accounted for.

In 20X9, the cumulative target is met as is the average target, therefore a diluted EPS is disclosed:

		Basic EPS		Diluted EPS
20X7	£780,000 ÷ 3,000,000 shares	£0.26		Not relevant
20X8	£655,000 ÷ 3,000,000 shares	£0.22		Not relevant
20X9	£745,000 ÷ 3,000,000 shares	£0.25	£745,000 ÷ 3,500,000 Shares	£0.21

7.3 Issue of contingently issuable shares

Where contingently issuable shares are issued at the end of a contingency period, they must be included within the calculation of basic EPS. Any outstanding contingently issuable shares are included in diluted EPS as discussed above.

Worked example: Contingently issuable shares

The profit attributable to the ordinary equity holders of an entity for the year ended 31 December 20X5 was £200 million and the number of its ordinary shares in issue at 1 January 20X5 was 80 million.

Under an agreement relating to a business combination, 12 million additional shares were to be issued each time the entity's products were ranked in the top three places in a consumer satisfaction survey conducted by a well-known magazine. A maximum of 36 million shares was issuable under this agreement and the products appeared in the top three places in surveys dated 28 February and 30 September 20X5.

There were no other issues of ordinary shares.

Requirement

Determine the basic and diluted EPS.

Solution

Basic earnings per share

The 24 million additional shares are weighted by the period they have been in issue:

	Issued	Weighting	Adjusted number
1 January 20X5 – 28 February	80,000,000	2/12	13,333,333
Issued 28 February	12,000,000		
1 March – 30 Sept	92,000,000	7/12	53,666,667
Issued 30 September	12,000,000		
30 September – 31 December	104,000,000	3/12	26,000,000
Weighted average shares in issue			93,000,000

CHAPTER 11

Basic earnings per share = £200m/93m = £2.15

Diluted earnings per share

As the 24 million additional shares do not result in any additional resources for the entity, the diluted calculation assumes all the new shares were issued at the start of the year (see section 2.4).

Diluted earnings per share = £200m/(80m + 12m + 12m) = £1.92

8 Retrospective adjustments, presentation and disclosure

Section overview

This section deals with retrospective adjustments to EPS and the provisions of IAS 33 concerning presentation and disclosure.

8.1 Retrospective adjustment

Bonus issues, share splits and share consolidations

If the number of ordinary or potential ordinary shares outstanding increases as a result of a capitalisation, bonus issue or share split, or decreases as a result of a share consolidation, the calculation of basic and diluted earnings per share for all periods presented must be adjusted retrospectively.

If these changes occur after the year end but before the financial statements are authorised for issue, EPS calculations for all periods presented must be based on the new number of shares.

The fact that EPS calculations reflect such changes must be disclosed.

Prior period adjustments and errors

Basic and diluted earnings per share of all periods presented must be adjusted for the effects of errors (IAS 8) and adjustments resulting from changes in accounting policies accounted for retrospectively.

DEPS

An entity does not restate diluted earnings per share of any prior period presented for changes in the assumptions used in earnings per share calculations or for the conversion of potential ordinary shares into ordinary shares.

8.2 Presentation

- Please note the following key points regarding presentation.
- Basic and diluted EPS for the year (and from continuing operations if reported separately) must be presented on the face of the statement of profit or loss and other comprehensive income with equal prominence for all periods presented.
- Where a separate statement of profit or loss is presented, basic and diluted EPS should be presented on the face of this statement.
- Earnings per share is presented for every period for which a statement of comprehensive income is presented.

- If diluted earnings per share is reported for at least one period, it shall be reported for all periods presented, even if it equals basic earnings per share.
- If basic and diluted earnings per share are equal, dual presentation can be accomplished in one line on the statement of comprehensive income.
- An entity that reports a discontinued operation shall disclose the basic and diluted amounts per share for the discontinued operation either on the face of the statement of comprehensive income or in the notes.
- An entity shall present basic and diluted earnings per share, even if the amounts are negative (ie, a loss per share).

8.3 Disclosure

An entity shall disclose the following:

- The amounts used as the numerators in calculating basic and diluted earnings per share, and a reconciliation of those amounts to profit or loss attributable to the parent entity for the period. The reconciliation shall include the individual effect of each class of instruments that affects earnings per share.
- The weighted average number of ordinary shares used as the denominator in calculating basic and diluted earnings per share, and a reconciliation of these denominators to each other. The reconciliation shall include the individual effect of each class of instruments that affects earnings per share.
- Instruments (including contingently issuable shares) that could potentially dilute basic earnings per share in the future, but were not included in the calculation of diluted earnings per share because they are antidilutive for the period(s) presented.
- A description of ordinary share transactions or potential ordinary share transactions, other than retrospective adjustments, that occur after the reporting date and that would have changed significantly the number of ordinary shares or potential ordinary shares outstanding at the end of the period if those transactions had occurred before the end of the reporting period.

Examples of transactions referred to in the paragraph above include the following:

- An issue of shares for cash
- An issue of shares when the proceeds are used to repay debt or preference shares outstanding at the reporting date
- The redemption of ordinary shares outstanding
- The conversion or exercise of potential ordinary shares outstanding at the reporting date into ordinary shares
- An issue of options, warrants, or convertible instruments
- The achievement of conditions that would result in the issue of contingently issuable shares

Earnings per share amounts are not adjusted for such transactions occurring after the reporting date because such transactions do not affect the amount of capital used to produce profit or loss for the period.

Financial instruments and other contracts generating potential ordinary shares may incorporate terms and conditions that affect the measurement of basic and diluted earnings per share. These terms and conditions may determine whether any potential ordinary shares are dilutive and, if so, the effect on the weighted average number of shares outstanding and any consequential adjustments to profit or loss attributable to ordinary equity holders. The disclosure of the terms and conditions of such financial instruments and other contracts is encouraged, if not otherwise required (refer also to IFRS 7, *Financial Instruments: Disclosures*).

8.4 Additional EPS

If an entity discloses, in addition to basic and diluted earnings per share, amounts per share using a reported component of profit other than one required by IAS 33, such amounts shall be calculated using the weighted average number of ordinary shares determined in accordance with this Standard.

Basic and diluted amounts per share relating to such a component shall be disclosed with equal prominence and presented in the notes.

An entity shall indicate the basis on which the numerator(s) is (are) determined, including whether amounts per share are before tax or after tax.

If a component of profit is used that is not reported as a line item in the statement of profit or loss and other comprehensive income, a reconciliation shall be provided between the component used and a line item that is reported in the statement of profit or loss and other comprehensive income.

Professional skills focus: Applying judgement

Judgement is needed as to whether the additional EPS potentially undermines the EPS as calculated in accordance with IAS 33. Although it is required by the standard to have equal prominence, the preparer of the financial statements needs to weigh up whether it is really necessary.

Context example: Allied Irish Bank plc

In addition to the required EPS under IAS 33, Allied Irish Bank plc reports an adjusted EPS measure excluding hedge volatility, profit on disposal of property and business and construction contract income. A comment to the disclosure states that the adjusted measure is presented to help better understand underlying business performance.

Allied Irish Bank plc 31 December 2006

Extract from Notes to the accounts:

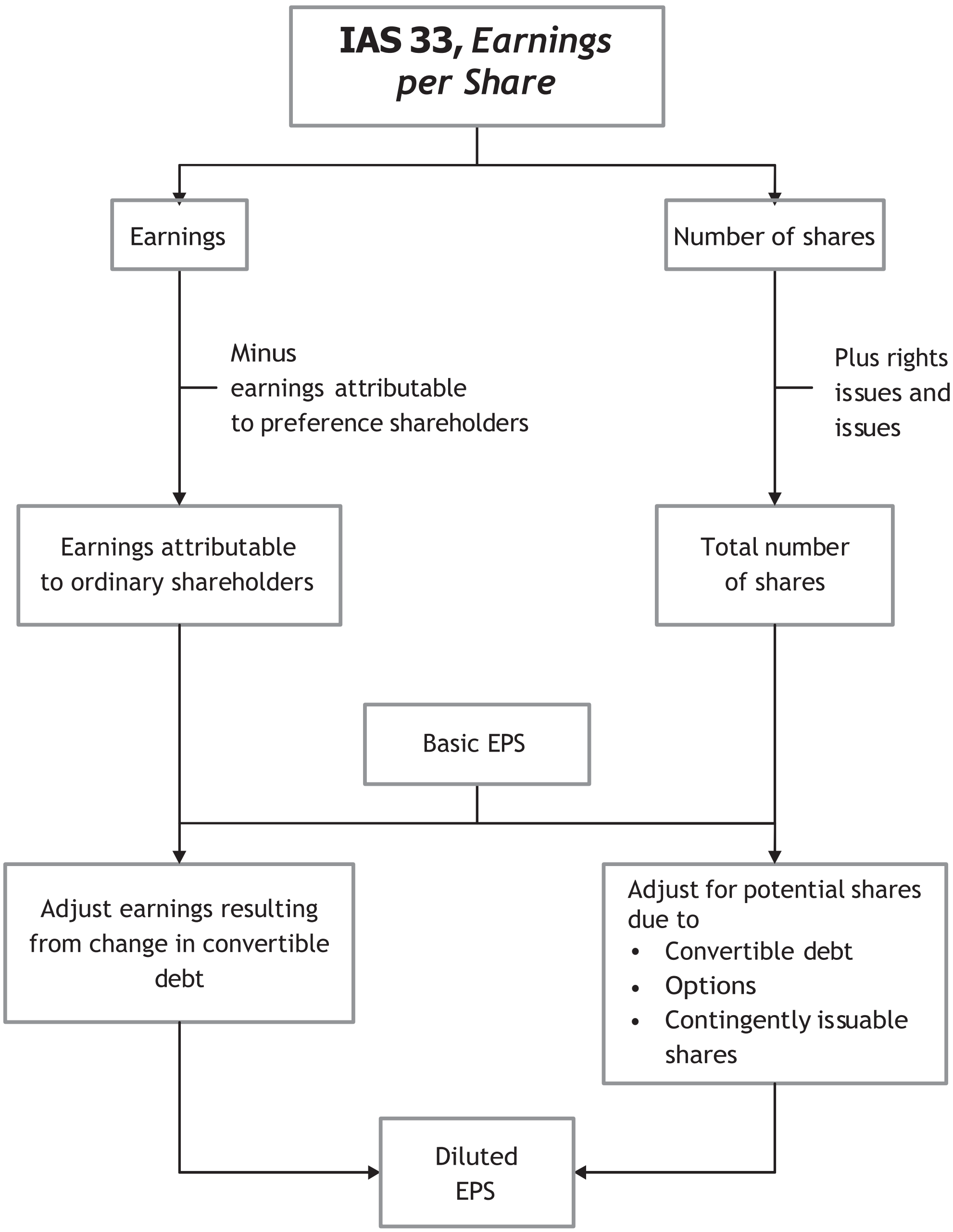
	Profit attributable		Earnings per share	
	2006	**2005**	**2006**	**2005**
19 Adjusted earnings per share	**€m**	**€m**	**€m**	**€m**
(a) Basic earnings per share				
As reported (Note 18(a))	2,147	1,305	246.8	151.0
Adjustments:				
Construction contract income	(82)	(38)	(9.4)	(4.4)
Hedge volatility	4	(6)	0.5	(0.7)
Profit on disposal of property	(290)	-	(33.4)	-
Profit on disposal of business	(189)		(21.7)	
	1,590	1,261	182.8	145.9

Although not required under IFRS® Standards, adjusted earnings per share is presented to help understand the underlying performance of the Group. The adjustments in 2006 and 2005 are items that management believe do not reflect the underlying business performance. The adjustment in respect of profit on sale of property relates only to the profit on sale of properties that are subject to sale and leaseback arrangements. The adjustments listed above are shown net of taxation.

Professional skills focus: Concluding, recommending and communicating

While earnings per share is a useful tool, users should be wary of relying solely on this figure. In particular, the context of the size of the entity, and the nature of its businesses should be taken into account.

Summary


IAS 33, *Earnings per Share*
Earnings
Number of shares
Minus
earnings attributable
to preference shareholders
Plus rights
issues and bonus
issues
Earnings attributable
to ordinary shareholders
Total number
of shares
Basic EPS
Adjust earnings resulting
from change in convertible
debt
Adjust for potential shares
due to
• Convertible debt
• Options
• Contingently issuable
shares
Diluted
EPS

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Can you calculate the weighted average number of shares for basic and diluted EPS? (Topic 2)
2.	Why is the distinction between redeemable and irredeemable preference shares significant? (Topic 3)
3.	What is meant by antidilutive? (Topic 4)
4.	Can you calculate EPS in the context of convertible shares and options? (Topic 7)
5.	Can you calculate EPS in the context of contingently issuable shares? (Topic 7)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Puffbird	A straightforward EPS question with a bonus issue and adjustment of the prior year figure, this is a good one to start on.
Whiting	An intermediate question, with a discontinued operation and convertible loan stock.
Citric	This is about as complicated as EPS gets, covering warrants and convertible bonds and test of dilution.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted the self-test questions, you can continue your studies by moving onto the next chapter.

In later chapters, we will recommend questions from the Question Bank for you to attempt. Earnings per share calculations often come at the end of scenario questions requiring adjustments to financial statements for financial reporting issues covered in later chapters.

1 Earnings

Amounts attributable to ordinary equity holders in respect of profit or loss for the period (and from continuing operations where reported separately) adjusted for the after tax amounts of preference dividends. – **IAS 33.12**

2 Shares

For the calculation of basic EPS the number of ordinary shares should be the weighted average number of shares outstanding during the period adjusted where appropriate for events, other than the conversion of shares, that have changed the number of ordinary shares outstanding without a corresponding change in resources. – **IAS 33.26**

3 Diluted earnings per share

For the purposes of calculating diluted earnings per share an entity shall adjust profit or loss attributable to ordinary equity holders and the weighted number of shares outstanding for the effects of dilutive potential ordinary shares. – **IAS 33.30, IAS 33.31**

4 Dilutive potential ordinary shares

Potential ordinary shares shall be treated as dilutive when, and only when, their conversion to ordinary shares could decrease earnings per share or increase loss per share from continuing operations. – **IAS 33.41**

5 Options, warrants and their equivalents – IAS 33.45

6 Convertible instruments – IAS 33.49

7 Contingently issuable shares – IAS 33.52

8 Retrospective adjustments

Basic and diluted EPS should be adjusted retrospectively for all capitalisations, bonus issues or share splits or reverse share splits that affect the number of shares in issue without affecting resources. – **IAS 33.64**

9 Presentation – IAS 33.66

10 Disclosure – IAS 33.70

Self-test questions

Answer the following questions.

1 Puffbird

Puffbird is a company listed on a recognised stock exchange. Its financial statements for the year ended 31 December 20X6 showed earnings per share of £0.95.

On 1 July 20X7 Puffbird made a 3 for 1 bonus issue.

Requirement

According to IAS 33, *Earnings per Share*, what figure for the 20X6 earnings per share will be shown as comparative information in the financial statements for the year ended 31 December 20X7?

2 Urtica

The Urtica Company is listed on a recognised stock exchange.

During the year ended 31 December 20X6, the company had 5 million ordinary shares of £1 and 500,000 6% irredeemable preference shares of £1 in issue.

Profit before tax for the year was £300,000 and the tax charge was £75,000

Requirement

According to IAS 33, *Earnings per Share*, what is Urtica's basic earnings per share for the year?

3 Issky

The following extracts relate to the Issky Company for the year ended 31 December 20X7.

Statement of comprehensive income

	£'000
Profit after tax	5,400

Statement of financial position

Ordinary shares of £1	8,400

In addition, the company had in issue throughout the year 1,800,000 share options granted to directors at an exercise price of £15. These were fully vested (ie, conditions required before these could be exercised were fulfilled and the options were exercisable) but had not yet been exercised. The market price for Issky's shares was £24 at 1 January 20X7, £30 at 31 December 20X7, and the average for 20X7 was £27.

Requirement

What is the diluted earnings per share for 20X7 according to IAS 33, *Earnings per Share*?

4 Whiting

The Whiting Company has the following financial statement extracts in the year ended 31 December 20X7.

Statement of comprehensive income

	£
Profit after tax	
Continuing operations	1,600,000
Discontinued operations	(400,000)
Total attributable to ordinary equity holders	1,200,000

Statement of financial position

Ordinary shares of £9,600,000 in £1 shares

On 1 January 20X7, Whiting issued £1.2 million of 7% redeemable convertible bonds, interest being payable annually in arrears on 31 December. The split accounting required of compound financial instruments resulted in the following classification.

	£
Equity component	100,000
Liability component	1,100,000
	1,200,000

The effective interest rate on the liability component is 10%. The bonds are convertible on specified dates in the future at the rate of one ordinary share for every £2 bond.

The tax regime under which Whiting operates gives relief for the whole of the charge based on the effective interest rate and applies a tax rate of 20%.

Requirement

Based upon the profit from continuing operations attributable to ordinary equity holders, what amount, if any, for diluted earnings per share should be presented by Whiting in its financial statements for the year ended 31 December 20X7 according to IAS 33, *Earnings per Share*?

5 Garfish

The Garfish Company had profits after tax of £3.0 million in the year ended 31 December 20X7.

On 1 January 20X7, Garfish had 2.4 million ordinary shares in issue. On 1 April 20X7 Garfish made a 1 for 2 rights issue at a price of £1.40 when the market price of Garfish's shares was £2.00.

Requirement

What is Garfish's basic earnings per share figure for the year ended 31 December 20X7, according to IAS 33, *Earnings per Share*?

6 Sakho

The Sakho Company has 850,000 ordinary shares in issue on 1 January 20X7 and had the following share transactions in the year ended 31 December 20X7.

(1) A 1 for 5 bonus issue on 1 May 20X7

(2) A 2 for 5 rights issue on 1 September 20X7 at £0.45 when the market price was £1.50

Requirement

Indicate whether the following statements are true or false according to IAS 33, *Earnings per Share*.

(1) The basic earnings per share for the year ended 31 December 20X6 has to be adjusted by a fraction of 5/6.

(2) For the calculation of 20X7 basic earnings per share, the number of shares in issue before the rights issue has to be adjusted by a rights fraction of 1.50/1.20.

7 Sardine

The Sardine Company operates in Moldania, a jurisdiction in which shares may be issued at a discount. It has profit after tax and before preference dividends of £200,000 in the year ended 31 December 20X7.

On 1 January 20X7 Sardine has in issue 500,000 ordinary shares, and on 1 January 20X7 issues £300,000 of £100 non-convertible, non-redeemable preference shares. Cash dividends of 8% per annum will only start to be paid on the preference shares from 1 January 20X9, so the shares are issued at a discount. The effective interest rate of the discount is 8%.

Requirement

According to IAS 33, *Earnings per Share*, what is the basic earnings per share for Sardine in the year ended 31 December 20X7?

8 Citric

The following information relates to The Citric Company for the year ended 31 December 20X7.

Statement of comprehensive income

Profit after tax – £100,000

Statement of financial position

Ordinary shares of £1 – 1,000,000

There are warrants outstanding in respect of 1.7 million new shares in Citric at a subscription price of

£18.00. Citric's share price was £22.00 on 1 January 20X7, £24.00 on 30 June 20X7, £30.00 on 31 December 20X7 and averaged £25.00 over the year.

On 1 January 20X7 Citric issued £2 million of 6% redeemable convertible bonds, interest being payable annually in arrears on 31 December. The split accounting required of compound financial instruments resulted in a liability component of £1.75 million and effective interest rate of 7%. The bonds are convertible on specified dates many years into the future at the rate of two ordinary shares for every £5 bonds.

The tax regime under which Citric operates gives relief for the whole of the effective interest rate charge on the bonds and applies a tax rate of 25%.

Requirement

Determine the following amounts in respect of Citric's diluted earnings per share for the year ending 31 December 20X7 according to IAS 33, *Earnings Per Share*:

(1) The number of shares to be treated as issued for no consideration (ie, 'free' shares) on the subscription of the warrants

(2) The earnings per incremental share on conversion of the bonds, expressed in pence (to one decimal place)

(3) The diluted earnings per share, expressed in pence (to one decimal place)

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

No, the 4% preference shares are classed as liabilities under IAS 32. The dividend has been charged to profits as part of the finance cost and no adjustment is necessary.

Answer to Interactive question 2

£1.75

Being the total earnings £350,000 divided by the number of shares in issue (200,000).

The redeemable preference share dividend is included as a finance cost and deducted in arriving at profit before tax.

Answer to Interactive question 3

Basic EPS
Trading results

	20X6
	£
Profit before interest and tax	1,050,000
Interest on 7% convertible loan stock	(105,000)
Profit before tax	945,000
Taxation	(283,500)
Profit after tax	661,500
Number of shares outstanding	2,000,000
Basic EPS (£661,500/2,000,000 shares)	£0.33

Testing for dilutive impact

Increase in earnings = interest saved (£1,500,000 × 7% × (1 – 30%)) – £73,500 Increase in number of shares (£1,500,000/£100 × 140) – 2,100,000

EPS (£73,500/2,100,000) = 3.5p

This is less than basic EPS and therefore the convertible loan stock is dilutive.

Answer to Interactive question 4

Diluted EPS

Trading results

CHAPTER 11

	20X7
	£
Profit after tax	900,000.00
Number of shares outstanding	3,000,000.00
Basic EPS	0.30
Number of shares under option	
Issued at full market price (600,000 × 50p)/£1.50	200,000.00

	20X7
	£
Issued at nil consideration 600,000 – 200,000	400,000.00
Total number of shares under option	600,000.00
Number of equity shares for basic EPS	3,000,000.00
Number of dilutive shares under option	400,000.00
Adjusted number of shares	3,400,000.00
Diluted EPS (£900,000/3,400,000)	0.26

Answers to Self-test questions

1 Puffbird

23.75 pence

Last year's EPS figure is adjusted by the reciprocal of the bonus fraction:

Bonus fraction = Number of shares post issue ÷ Number of shares pre issue = 4 ÷ 1 Therefore

revised EPS = 95p × ¼ = 23.75p

2 Urtica

3.9 pence

IAS 33 12–13 define earnings for basic EPS as after tax and after dividends on irredeemable preference shares.

	£
Profit before tax	300,000
Tax	(75,000)
Profit after tax	225,000
Preference dividend (£500,000 × 6%)	(30,000)
Profit attributable to ordinary equity holders	195,000

Therefore BEPS = £195,000/5,000,000 shares = 3.9p

3 Issky

58.7 pence

Number of shares under option	
Issued at average market price (£15 × 1,800,000)/£27	1,000,000
Issued at nil consideration (1,800,000 – 1,000,000)	800,000
Number of equity shares for basic EPS	8,400,000
Number of dilutive shares under option	800,000
Adjusted number of shares	9,200,000

Diluted EPS (£5,400,000/9,200,000 shares) = 58.7p

According to IAS 33.46, the proceeds of the options should be calculated using the average market price during the year. The difference between the number of ordinary shares issued and the number that would have been issued at the average market price are the 'free' shares that create the dilutive effect.

4 Whiting

16.6 pence

Basic EPS	Based on continuing operations £1,600,000 ÷ 9,600,000	16.7 p
Incremental EPS	Increment to profits after conversion of bonds: £1,100,000 × 10% × (1 – 20%) = £88,000 Increase to number of shares: £1,200,000/£2 = 600,000 Therefore: £88,000 ÷ 600,000	14.7 p
Diluted EPS	Based on continuing operations £(1,600,000 + 88,000) ÷ (9,600,000 + 600,000 shares)	16.6 p

The shares issuable on conversion of the bonds are potentially dilutive, but IAS 33.41 only requires them to be taken into account if they dilute the basic EPS figure based on continuing operations.

5 Garfish

89.1 pence

Weighted average number of shares:

TERP	2	Shares @ £2.00 =	£4.00	
	1	Shares @ £1.40 =	£1.40	
	3		£5.40	Therefore £5.40/3 = £1.80

Adjustment factor: Market value of share ÷ TERP = £2.00 ÷ £1.80

1 Jan X7 – 31 March X7	2,400,000 × (2.00 ÷ 1.80) × 3/12	666,667
Rights issue	1,200,000	
1 April X7 – 31 Dec X7	3,600,000 × 9/12	2,700,000
		3,366,667

Basic EPS:

£3,000,000 ÷ 3,366,667 shares = 89.1p

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Statements

(1) False

(2) True

Bonus fraction = Number of shares post issue ÷ Number of shares pre issue = 6 ÷ 5 Rights adjustment factor = MV of share ÷ TERP = 1.50 ÷ 1.20

TERP	5	Shares @ £1.50 =	£7.50	
	2	Shares @ £0.45 =	£0.90	
	7		£8.40	Therefore £8.40/7 = £1.20

The basic EPS for the prior year is multiplied by the inverse of the rights factor and the bonus factor, so 1.20/1.50 × 5/6 = 2/3.

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35.9 pence

Issue price of preference shares = £300,000/1.08^2 = £257,202

Profit attributable to ordinary equity holders = £200,000 – (8% × £257,202) = £179,424

Basic EPS = £179,424 ÷ 500,000 shares = 35.9p

As no dividend is payable on the preference shares in 20X7, the discount on issue is amortised using the effective interest method and treated as preference dividend when calculating earnings for EPS purposes (IAS 33.15).

The £300,000 preference shares must be discounted at 8% for the two years between issue and the date when dividends commence. A dividend is then calculated at 8% per annum compound on that value.

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Diluted EPS

(1) 476,000

(2) 11.5 pence

(3) 6.78 pence

Explanation

(1) Shares issued at average market price (1,700,000 × £18)/£25 = 1,224,000 Shares issued at nil consideration (1,700,000 – 1,224,000) = 476,000

(2) Incremental profits (£1,750,000 × 7% × (1 – 25%)) = £91,875 Increase in number of shares (£2,000,000/£5 × 2) = 800,000 Therefore incremental EPS (£91,875/800,000 shares) = 11.5p (3)

	Profits	Number of shares	EPS
Basic EPS	£100,000	1,000,000	10p
Add in options	£100,000	1,446,000	6.78p

The warrants (treated as issued for nil consideration) are more dilutive than the bonds, so are dealt with first under IAS 33.44. As the 11.5 pence earnings per incremental share on conversion of the bonds is antidilutive, under IAS 33.36 the conversion is left out of the calculation of diluted EPS.

Chapter 12

Reporting of assets

Introduction

Learning outcomes

- Explain how different methods of recognising and measuring assets and liabilities can affect reported financial position and explain the role of data analytics in financial asset and liability valuation
- Explain and appraise accounting standards that relate to assets and non-financial liabilities for example: property, plant and equipment; intangible assets, held-for-sale assets; inventories; investment properties; provisions and contingencies
- Determine for a particular scenario what comprises sufficient, appropriate audit evidence
- Design and determine audit procedures in a range of circumstances and scenarios, for example identifying an appropriate mix of tests of controls, analytical procedures and tests of details
- Demonstrate and explain, in the application of audit procedures, how relevant ISAs affect audit risk and the evaluation of audit evidence

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
1	**Review of material from earlier studies** Section 1 gives a brief revision of standards covered in great detail in terms of content and application at Professional Level. They address the reporting of assets, impairment, liabilities, provisions and contingencies and events after the reporting period. These are likely to be examined in an integrated way with other areas at Advanced Level.	**Approach** Read the summary of knowledge brought forward and try the relevant questions. If you have any difficulty, go back to your earlier study material and revise it. Use the questions in the electronic Self-test bank for further revision. **Stop and think** What is the definition of an asset in the 2018 *Conceptual*	Just because these standards are tested at earlier levels does not mean that questions that include them will be easy. These are likely to be examined in an integrated way with other areas at Advanced Level. For example, a question on property may range from owner-occupied (IAS 16) to investment property (IAS 40) to leasehold property	**IQ2: Impairment loss** You should aim to do all the interactive questions because you will struggle to tackle a complex scenario question without a knowledge of the basics. This question is the one to focus on.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
	Inventories can often be the most significant current asset in an entity's statement of financial position. In addition, whether an asset is capitalised or not, the value attributed to it and how it is depreciated or not has a significant impact on the financial statements.	*Framework*?	(IFRS 16, covered in Chapter 14).	
2	**IAS 40, *Investment Property*** Entities may invest in property (IAS 40) for the potentially attractive returns that are available from capital gains and rental income. Measuring such investment properties as a series of out-of-date historic costs is not an appropriate reflection of volatility caused by changes in property values.	**Approach** This is a new standard at Advanced Level, so work through carefully. Make sure you can distinguish investment property from owner-occupied property, that you know when to recognise investment property and how to measure it, and can deal with a change of use. **Stop and think** An investment property held under the fair value model is developed for future sale. How should it be accounted for?	Investment property comes up quite regularly as part of a longer scenario question and in the context of audit and fair value (IFRS 13). With IFRS 16, *Leases* being a topical standard, expect to see examined the interaction between this and IAS 40.	**IQ11: Replacement property** Although short, this is a useful question because it tests how IAS 40 interacts with other standards.
3	**IAS 41, *Agriculture*** Working in the context of the agricultural sector or of extractive industries you will need to make judgements on the	**Approach** This standard is set at level A, so this section should be studied carefully, even though the topic has not yet been examined. Do	This topic has yet to be examined.	**IQ13: Costs to sell** This is a quick, test-your-knowledge question.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
	valuation of biological assets/the appropriate capitalisation of expenditure. Since the use of a historic cost model was not seen as wholly appropriate for accounting for agricultural activity IAS 41, *Agriculture* is based on a fair value model.	both interactive questions. **Stop and think** What are bearer biological assets?		
4	**IFRS 6, *Exploration for and Evaluation of Mineral Resources*** Entities such as those in the oil and gas industry follow a wide range of practices for the accounting of exploration and evaluation expenditure (IFRS 6).	**Approach** This is examinable at level D, so is not a key topic. Read through quickly. The key point is that the recognition criteria for impairment are different from IAS 36 but, once impairment is recognised, the measurement criteria are the same as for IAS 36. **Stop and think** How should these assets be measured on initial recognition?	This topic has yet to be examined.	N/A
5	**IFRS 4, *Insurance Contracts*** IFRS 4 provides **interim guidance** on accounting for insurance contracts. It will be replaced in 2023 by IFRS 17.	**Approach** This is examinable at level D, so should not be prioritised at the expense of key standards, such as IAS 40. **Stop and think** Focus more on other standards!	This topic has yet to be examined.	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
6	**Audit focus points** This section focuses on the audit of investment properties, as the other key topics were covered at Professional Level.	**Approach** Read and learn the table in Section 6.2, which gives an approach to auditing classification, valuation and disclosure. **Stop and think** Why might investment property be more risky than owner-occupied property?	You are very likely to get investment property as part of an integrated financial reporting and auditing question.	**IQ14: Investment property and fair value** A typical scenario as part of Question 3, covering both audit issues and audit procedures in relation to IAS 40 and IFRS 13.

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Review of material from earlier studies

Section overview

You should already be familiar with the standards relating to current and non-current assets from earlier studies. If not, go back to your earlier study material.

- IAS 2, *Inventories*
- IAS 16, *Property, Plant and Equipment*
- IAS 38, *Intangible Assets*
- IAS 36, *Impairment of Assets*

Read the summary of knowledge brought forward and try the relevant questions. If you have any difficulty, go back to your earlier study material and revise it.

Assets have been defined in many different ways and for many purposes. The definition of an asset is important because it directly affects the **treatment** of such items. A good definition will prevent abuse or error in the accounting treatment: otherwise some assets might be treated as expenses, and some expenses might be treated as assets.

In the current accounting climate, where complex transactions are carried out daily a definition that covers ownership and value is not sufficient, leaving key questions unanswered.

- What determines ownership?
- What determines value?

The definition of an asset in the IASB's *Conceptual Framework for Financial Reporting* from earlier studies is given below.

Definition

Asset: A present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits. (*Conceptual Framework, para. 4.2*)

This definition ties in closely with the definitions produced by **other standard-setters**, particularly the FASB (USA) and the ASB (UK).

A general consensus seems to exist in the standard setting bodies as to the definition of an asset which encompasses **three important characteristics**.

- Future economic benefit
- Control
- The transaction to acquire control has already taken place

1.1 Property, plant and equipment

The following concepts will be familiar to you from your earlier studies.

- **Cost** is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction.
- **Residual value** is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

- **Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (Note that this definition changed when IFRS 13, *Fair Value Measurement* came into force in January 2013.
- **Carrying amount** is the amount at which an asset is recognised after deducting any accumulated depreciation and accumulated impairment losses.

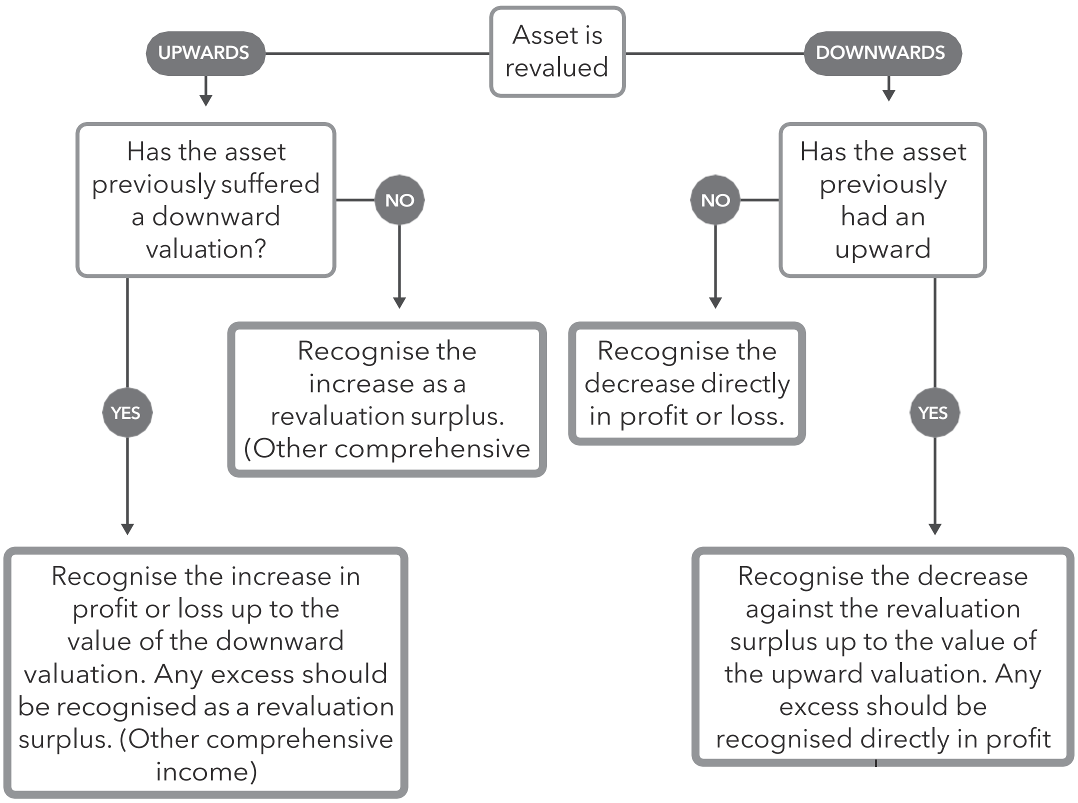
Accounting treatment

- As with all assets, **recognition** depends on two criteria:
  - It is probable that **future economic benefits** associated with the item will flow to the entity.
  - The cost of the item can be **measured reliably.**
- These recognition criteria apply to **subsequent expenditure** as well as costs incurred initially (ie, there are no longer separate criteria for recognising subsequent expenditure).
- Once recognised as an asset, items should **initially be measured at cost**.
- Cost is the **purchase price**, less trade discount/rebate plus:
  - **directly attributable costs** of bringing the asset to working condition for intended use; and
  - **initial estimate** of the **unavoidable cost of dismantling and removing the item** and **restoring the site** on which it is located.

IAS 16, *Property, Plant and Equipment* also does the following:

- Provides additional guidance on directly attributable costs, including the cost of an item of property, plant and equipment
- States that income and related expenses of operations that are incidental to the construction or development of an item of property, plant and equipment should be recognised in profit or loss for the period
- Specifies that exchanges of items of property, plant and equipment, regardless of whether the assets are similar, are measured at **fair value**, unless the exchange transaction lacks commercial substance or the fair value of neither of the assets exchanged can be measured reliably. If the acquired item is not measured at fair value, its cost is measured at the carrying amount of the asset given up
- Permits a **choice of measurement models subsequent to initial recognition**
  - **Cost model**: carrying asset at cost less depreciation and any accumulated impairment losses
  - **Revaluation model**: carrying asset at revalued amount, ie, fair value less subsequent accumulated depreciation and any accumulated impairment losses. (IAS 16 makes clear that the revaluation model is available only if the fair value of the item can be measured reliably.)

Figure 12.1: Revaluations



Professional skills focus: Structuring problems and solutions

The above flowchart is an example of how to structure a problem, in this case PPE revaluations. It should form part of your revision.

Interactive question 1: Revaluations

Binkie Co has an item of land carried in its books at £13,000. Two years ago a slump in land values led the company to reduce the carrying amount from £15,000. This was recorded as an expense. There has been a surge in land prices in the current year, however, and the land is now worth £20,000.

In the example given above assume that the original cost was £15,000, revalued upwards to £20,000 two years ago. The value has now fallen to £13,000.

Crinkle Co bought an asset for £10,000 at the beginning of 20X6. It had a useful life of five years. On 1 January 20X8 the asset was revalued to £12,000. The expected useful life has remained unchanged (ie, three years remain).

Requirements

1.1 Account for the revaluation in the current year

1.2 Account for the decrease in value

1.3 Account for the revaluation and state the treatment for depreciation from 20X8 onwards.

See **Answer** at the end of this chapter.

1.2 Inventories

Valuation	Allowable costs
Lower of: • Cost • Net realisable value Each item/group/category considered separately	Include: • Cost of purchase Exclude: • Cost of storage • Cost of selling
Determining cost • First in, first out (FIFO) • Weighted average cost	**Net realisable value** • Estimated cost of completion • Estimated costs necessary to make the sale (eg, marketing, selling and distribution)

1.3 IAS 38, *Intangible Assets*

- An **intangible asset** is an **identifiable non-monetary asset without physical substance**, such as a licence, patent or trademark.
- An intangible asset is **identifiable** if it is **separable** (ie, it can be sold, transferred, exchanged, licensed or rented to another party on its own rather than as part of a business) or it arises from **contractual or other legal rights**.
- An intangible asset should be recognised if it is probable that future economic benefits **attributable to the asset** will flow to the entity and the **cost** of the asset can be **measured reliably**.
- At recognition the intangible should be recognised at cost (purchase price plus directly attributable costs). After initial recognition an entity can **choose** between the **cost model** and the **revaluation model**. The revaluation model can only be adopted if an **active market** (as defined) exists for that type of asset.
- An intangible asset (other than goodwill recognised in the acquiree's financial statements) **acquired as part of a business combination** should initially be recognised **at fair value**.
- Internally generated goodwill should **not** be recognised.
- Expenditure incurred in the **research phase** of an internally generated intangible asset should be **expensed as incurred**.
- Expenditure incurred in the **development phase** of an internally generated intangible asset **mustbe capitalised** provided **certain tightly defined criteria are met**.
  - Expenditure incurred before the criteria being met may not be capitalised retrospectively.
- An intangible asset with a **finite useful life** should be **amortised** over its expected useful life, **commencing** when the asset is **available for use** in the manner intended by management.
- Residual values should be assumed to be nil, except in the rare circumstances when an active market exists or there is a commitment by a third party to purchase the asset at the end of its useful life.
- An intangible asset with an **indefinite life** should **not be amortised**, but should be reviewed for **impairment** on an **annual basis**.
  - There must also be an annual review of whether the indefinite life assessment is still appropriate.
- On disposal of an intangible asset the gain or loss is recognised in profit or loss.

1.4 IAS 36, *Impairment of Assets*

1.4.1 Key points

Recoverable amount	An asset's recoverable amount is the higher of **value in use** (net cash flows) and **fair value less costs of disposal**. Impairment losses occur where the **carrying amount** of an asset is **above its recoverable amount**.
Impairment indicators	An entity must do an impairment test when there are **impairment indicators**. These can be **internal** or **external**.
Cash-generating units	Where cash flows cannot be measured separately, the recoverable amount is calculated by reference to the **CGU**.
Recognition of impairment losses	Impairment losses are charged **first to other comprehensive income** (re any revaluation surplus relating to the asset) and then to profit or loss. In the case of a CGU, the credit is allocated **first against any goodwill** and then pro-rata over the other assets of the CGU.
After the impairment review	After the impairment review, depreciation/amortisation is allocated over the asset's **revised remaining useful life**.

Interactive question 2: Impairment loss

An entity has a single manufacturing plant which has a carrying value of £749,000. A new government elected in the country passes legislation significantly restricting exports of the product produced by the plant. As a result, and for the foreseeable future, the entity's production will be cut by 40%. Cash flow forecasts have been prepared derived from the most recent financial budgets/forecasts for the next five years approved by management (excluding the effects of general price inflation).

Year	1	2	3	4	5
	£'000	**£'000**	**£'000**	**£'000**	**£'000**
Future cash flows	230	211	157	104	233 (including disposal proceeds)

If the plant was sold now it would realise £550,000, net of selling costs.

The entity estimates the pre-tax discount rate specific to the plant to be 15%, after taking into account the effects of general price inflation.

Requirement

Calculate the recoverable amount of the plant and any impairment loss.

Note: PV factors at 15% are as follows.

Year	**PV factor @15%**
1	0.86957
2	0.75614
3	0.65752
4	0.57175
5	0.49718

See **Answer** at the end of this chapter.

Professional skills focus: Applying judgement

Judgement must be applied in considering whether an item is a cash-generating unit. Both in the exam, and in real life, it may not be obvious.

Interactive question 3: Cash-generating units

Discuss whether the following items would be cash-generating units in their own right, or part of a larger cash-generating unit.

(1) A pizza oven in a pizza restaurant

(2) A branch of a pizza restaurant in Warsaw

(3) A monorail that takes fee paying visitors to a theme park from its car park

(4) A monorail that transports fee paying commuters from a suburban part of town to the centre of town

(5) The internal large telephone network of a country's railway system, although its use is currently not permitted to anybody other than railway workers

See **Answer** at the end of this chapter.

1.4.2 Treatment of the non-controlling interest element of goodwill

The revision to IFRS 3 allows two methods of initially valuing the non-controlling (minority) interest in an entity:

- As a share of the net assets of the entity at the acquisition date; or
- at fair value.

The non-controlling interest is then taken into account in the goodwill calculation per the revised standard:

Purchase consideration	X
Non-controlling interest	<u>X</u>
	X
Total fair value of net assets of acquiree	<u>(X)</u>
Goodwill	<u>X</u>

This means that the resulting goodwill will represent:

- only the parent's share of total goodwill when valuing the non-controlling interest using the proportion of net assets method; and
- full goodwill (ie, the parent's share plus the non-controlling interest share) when using the fair value method.

Where the share of net assets method is used to value the non-controlling interest, the carrying amount of a CGU therefore comprises:

- the parent and non-controlling share of the identifiable net assets of the unit; and
- only the parent's share of the goodwill.

Part of the calculation of the recoverable amount of the CGU relates to the unrecognised share in the goodwill.

For the purpose of calculating the impairment loss, the carrying amount of the CGU is therefore notionally adjusted to include the non-controlling share in the goodwill by grossing it up.

The consequent impairment loss calculated is only recognised to the extent of the parent's share. Where the fair value method is used to value the non-controlling interest, no adjustment is required.

Interactive question 4: Allocation of impairment loss

Peter acquired 60% of Stewart on 1 January 20X1 for £450 million recognising net assets of £600 million, a non-controlling interest (valued as a proportion of total net assets) of £240 million and goodwill of £90 million. Stewart consists of a single cash-generating unit.

Due to adverse publicity, the recoverable amount of Stewart had fallen by 31 December 20X1. The depreciated value of the net assets at that date was £550 million (excluding goodwill). No impairment losses have yet been recognised relating to the goodwill.

Requirement

Show the allocation of the impairment losses:

(1) if the recoverable amount was £510 million at 31 December 20X1

(2) if the recoverable amount was £570 million at 31 December 20X1

See **Answer** at the end of this chapter.

1.4.3 Reversal of past impairments

A reversal for a CGU is allocated to the assets of the CGU, except for goodwill, pro rata with the carrying amounts of those assets.

However, the carrying amount of an asset is not increased above the lower of:

- its recoverable amount (if determinable); and
- its depreciated carrying amount had no impairment loss originally been recognised.

Any amounts left unallocated are allocated to the other assets (except goodwill) pro rata.

The reversal is recognised in profit or loss, except where reversing a loss recognised on assets carried at revalued amounts, which are treated in accordance with the applicable IFRS® Standard.

For example, an impairment loss reversal on property, plant and equipment first reverses the loss recorded in profit or loss and any remainder is credited to the revaluation surplus (IAS 16).

Goodwill

Once recognised, impairment losses on goodwill are **not reversed**.

1.4.4 Impairment and IFRS 5

IFRS 5 is covered in detail in Chapter 9. Regarding impairment, note the following:

- Immediately before initial classification as held for sale, the asset (or disposal group) is **measured in accordance with the applicable IFRS** (eg, property, plant and equipment held under the IAS 16 revaluation model is revalued).
- On classification of the non-current asset (or disposal group) as held for sale, it is **written down to fair value less costs to sell** (if less than carrying amount).
- Any impairment loss arising under IFRS 5 is **charged to profit or loss** (and the credit

allocated to assets of a disposal group using the IAS 36 rules, ie, first to goodwill then to other assets pro rata based on carrying value).

- Non-current assets/disposal groups classified as held for sale are ***not* depreciated/amortised.**
- Any subsequent changes in fair value less costs to sell are **recognised as a further impairment** loss (or reversal of an impairment loss).
- However, gains recognised **cannot exceed cumulative impairment losses** to date (whether under IAS 36 or IFRS 5).

2 IAS 40, *Investment Property*

Section overview

- An investment property is land or buildings or both that is held by an entity to earn rentals and/or for its capital appreciation potential.
- Following initial measurement, investment property may be measured using the cost model or the fair value model.

One of the distinguishing characteristics of **investment property** is that it generates cash flows largely independent of the other assets held by an entity.

Owner-occupied property is not investment property and is accounted for under IAS 16, *Property, Plant and Equipment*.

2.1 Recognition

Investment property should be recognised as an asset when **two conditions** are met.

- It is **probable** that the **future economic benefits** that are associated with the investment property will **flow to the entity**.
- The **cost** of the investment property can be **measured reliably**.

2.2 Initial measurement and further aspects of recognition

An investment property should initially be measured at its cost, including transaction costs.

Further aspects of recognition	
Transaction costs	Expenses that are directly attributable to the investment property, for example professional fees and property transfer taxes. Cost does not include activities that, while related to the investment property, are not directly attributable to it. For example, start-up costs, abnormal amounts of wasted resources in constructing the property, relocation costs, losses incurred before full occupancy and the normal servicing of the property are not directly attributable.
Self-constructed investment properties	Property being self-constructed or under development for future use as an investment property qualifies itself as an investment property.

Leases	An investment property held by a lessee as a right-of-use asset must be recognised in accordance with IFRS 16, *Leases* (see Chapter 14).
Entity occupies part of property and leases out balance	If the two portions can be sold separately or leased separately, each is accounted for as appropriate. If not, entire property is an investment property only if **insignificant** portion is owner occupied.
Entity supplies services to the lessee of the property	An investment property only if the services are insignificant to the arrangement as a whole.
Property leased to and occupied by parent, subsidiary or other group company	An investment property in entity's own accounts but owner occupied from group perspective.

Interactive question 5: Identification of investment property

(1) An entity has a factory that has been shut down due to chemical contamination, worker unrest and strike. The entity plans to sell this factory.

(2) An entity has purchased a building that it intends to lease out under an operating lease.

(3) An entity has acquired a large-scale office building, with the intention of enjoying its capital appreciation. Rather than holding it empty, the entity has decided to try to recover its running costs by renting the space out for periods which run from one week to one year. To make the building attractive to potential customers, the entity has fitted the space out as small office units, complete with full-scale telecommunications facilities, and offers reception, cleaning, a loud speaker system and secretarial services. The expenditure incurred in fitting out the offices has been a substantial proportion of the value of the building.

(4) An entity acquired a site on 30 April 20X4 with the intention of building office blocks to let. After receiving planning permission, construction started on 1 September 20X4 and was completed at a cost of £10 million on 30 March 20X5 at which point the building was ready for occupation.

The building remained vacant for several months and the entity incurred significant operating losses during this period.

The first leases were signed in July 20X5 and the building was not fully let until 1 September 20X6.

Requirement

Do the buildings referred to in (1)–(4) above meet the definition of investment property?

See **Answer** at the end of this chapter.

2.3 Measurement subsequent to initial recognition

Following initial measurement, investment properties are held **either**:

- at cost less accumulated depreciation (the **cost model**); or
- measured at fair value (the **fair value model**).

2.3.1 Cost model

Where the cost model is adopted, the property should be accounted for in accordance with IAS 16, *Property, Plant and Equipment*.

2.3.2 Fair value model

- After initial recognition, an entity that chooses the **fair value model** should measure all of its investment property at fair value, except in the extremely rare cases where this cannot be measured reliably. In such cases it should apply the IAS 16 cost model.
- A gain or loss arising from a change in the fair value of an investment property should be recognised in net profit or loss for the period in which it arises.
- The fair value of investment property should reflect market conditions at the reporting date.
- A change in use of an investment property may lead to a change in classification.

Whatever policy the entity chooses should be applied to **all of its investment property**.

Interactive question 6: Estimating fair value

An entity with a 31 December year end owns the freehold of an office block standing on a city centre site on which there are four other similar buildings, none of which are owned by the entity. All the office buildings were constructed at the same time as the entity's building and the floors in all five buildings are let out on standard 25-year leases.

Requirements

Which of the following values could be used by the entity as a basis for estimating the fair value of its office building at 31 December 20X5, according to IAS 40?

6.1 The first of the other office buildings changed hands early in 20X5 for £5 million as a result of an auction which was widely publicised in the professional property press.

6.2 The second of the other office buildings changed hands late in 20X5 for £6 million as a result of a sale to an entity, 55% of whose shares were owned by the seller.

6.3 The third of the other office buildings changed hands late in 20X5 for £4.5 million as a result of sale to a financial institution to which the seller owed £3.5 million. It is understood that the seller had breached its banking covenants and had to raise cash by the end of 20X5.

6.4 The fourth of the other office buildings changed hands late in 20X5 for £5.5 million as a result of a sale to an overseas institution which was seeking to establish its first foothold in the country's property market. The offer of the office building was widely publicised in the professional property press although it is understood that local institutions were only prepared to offer in the region of £4.9 million.

See **Answer** at the end of this chapter.

2.4 Derecognition

When an investment property is derecognised, a gain or loss on disposal should be recognised in profit or loss. The gain or loss should normally be determined as the difference between the net disposal proceeds and the carrying amount of the asset.

Interactive question 7: Disposal of investment property

An entity purchased an investment property on 1 January 20X3, for a cost of £5.5 million. The property has a useful life of 50 years, with no residual value and at 31 December 20X5 had a fair value of £6.2 million. On 1 January 20X6 the property was sold for net proceeds of £6 million.

Requirement

Calculate the profit or loss on disposal under both the cost and fair value model.

See **Answer** at the end of this chapter.

2.5 Transfers following a change in use

A change in use may lead to recognition or de-recognition of an investment property. The following is a summary of such instances.

Evidence of change in use	Accounting treatment
Commencement of owner occupation	• Owner-occupied property recognised under IAS 16. • If fair value model was used, treat fair value as deemed cost.
Commencement of development with a view to sale	• Reclassify as inventory under IAS 2. • If fair value model was used, treat fair value as deemed cost.
Development with view to continue letting	• Continue to hold as an investment property.
End of owner occupation with view to let to third parties	• Transfer to investment properties under IAS 40. • If fair value model to be used, revalue at date of change and recognise difference as revaluation under IAS 16.
Property held as inventory now let to a third party	• Transfer to investment properties under IAS 40. • If fair value model to be used, revalue at date of change and recognise difference in profit or loss.
Commencement of lease to another party	• Transfer from property, plant and equipment to investment property under IAS 40.

Professional skills focus: Assimilating and using information

When considering a change of use, it is important to understand all the required evidence about its current use and its future use, including the model that is to be used. The current use affects the future accounting treatment.

Professional skills focus: Concluding, recommending and communicating

It is possible that you may, in an exam, come to the wrong conclusion about change of use, but you will gain credit for any valid arguments that led you to your conclusion, and which are clearly communicated.

Interactive question 8: Change of use

An entity with a 31 December year end purchased an office building, with a useful life of 50 years, for £5.5 million on 1 January 20X1. The amount attributable to the land was negligible. The entity used the building as its head office for five years until 31 December 20X5 when the entity moved its head office to larger premises. The building was reclassified as an investment property and leased out under a five-year lease.

Owing to a change in circumstances the entity took possession of the building five years later on 31 December 20Y0, to use it as its head office once more. At that date the remaining useful life of the building was confirmed as 40 years.

The fair value of the head office was as follows.

- At 31 December 20X5 £6 million
- At 31 December 20Y0 £7.5 million

Requirements

How should the changes of use be reflected in the financial statements on the assumption that:

(a) the entity uses the cost model for investment properties?

(b) the entity uses the fair value model for investment properties?

See **Answer** at the end of this chapter.

2.6 Summary of disclosure requirements

An entity shall disclose the following:

- Whether it has followed the fair value model or cost model
- Whether property interests held as leases are included in investment property
- Criteria for classification as investment property
- Assumptions in determining fair value
- Use of independent professional valuer (encouraged but not required)
- Rental income and expenses
- Any restrictions or obligations

2.6.1 Fair value model – additional disclosures

An entity that adopts this must also disclose a **reconciliation** of the carrying amount of the investment property at the beginning and end of the period.

2.6.2 Cost model – additional disclosures

These relate mainly to the depreciation method, rates and useful lives used as well as a reconciliation of the carrying amount at the beginning and end of the period. In addition, an entity which adopts the cost model **must disclose the fair value** of the investment property.

Interactive question 9: Installation of new equipment 1

An entity owns the freehold of an office building which was acquired on 31 December 20X0 for £17 million, £2 million of which was attributable to the land. The freehold is an investment property measured under the cost model with the building's useful life estimated at 30 years. The building was fully equipped with an air-conditioning system. No separate value was placed on the air conditioning unit as this was not something that was required by accounting standards at the time of acquisition.

On 31 December 20X5 the entity replaced the air-conditioning system for £1.2 million, which has an estimated useful life of 10 years. As no more reliable information was available, it used this cost as an indication of the cost of the old system.

Requirement

How should the replacement of the air-conditioning be accounted for?

See **Answer** at the end of this chapter.

Interactive question 10: Installation of new equipment 2

An entity with a 31 December year end owns an office building which is recognised as an investment property. The lift system is an integral part of the office building. The entity uses the fair value model for measurement of investment properties.

The lift system was purchased on 1 January 20X0 for £400,000 and is being depreciated at 12.5% per annum on cost. Its carrying amount has been accepted as a reasonable value at which to include it within the fair value of the office building as a whole.

Early in December 20X5 a professional valuer determined the fair value of the office building, including the lift system, to be £3 million. The lift system failed on 28 December 20X5 and was immediately replaced on 31 December 20X5 with a new system costing £600,000.

Requirement

How should the lift system be recognised?

See **Answer** at the end of this chapter.

Interactive question 11: Replacement property

An entity with a 31 December year end owns an investment property which it measures using the fair value model. At 31 December 20X4, the property's carrying amount is £4 million. On 30 June 20X5, an explosion close to the property causes major damage to the property. In July 20X5, the entity makes a number of insurance claims as a result, one of which is for the rebuilding cost, estimated at £3.7 million.

Although the property is repairable, the entity decides to sell it in its present state and buy a replacement property. This decision is made on 30 September 20X5, on which date the damaged property meets the criteria for classification as held for sale. Its fair value on that date is £350,000 and the costs to sell are £35,000. The fair value does not change between 30 September 20X5 and 31 December 20X5. The sale is completed in the middle of 20X6 for £375,000, with selling costs of £40,000.

On 1 March 20X6, the entity acquires a replacement property for £3.8 million.

The entity's insurers contest the claim relating to the building on the basis of an exclusion clause. The entity disagrees with the insurers' interpretation and in February 20X6 initiates legal proceedings.
Negotiations are protracted and it is not until the end of 20X7 that the insurers agree to settle for £3.9 million.

Requirement

How should the entity recognise these transactions? See **Answer** at the end of this chapter.

3 IAS 41, *Agriculture*

Section overview

IAS 41 sets out the accounting treatment, including presentation and disclosure requirements, for agricultural activity.

3.1 Definitions

Definitions

Agricultural activity: Defined as the management of the biological transformation of biological assets for sale, into agricultural produce, or into additional biological assets.

Agricultural activities include, for example, raising livestock, forestry and cultivating orchards and plantations.

In its simplest form a biological transformation is the process of growing something such as a crop, although it also incorporates the production of agricultural produce such as wool and milk.

Biological transformation: Comprises the processes of growth, degeneration, production and procreation that cause qualitative or quantitative changes in a biological asset.

Biological asset: A living plant or animal.

Agricultural produce: The harvested produce of an entity's biological assets.

IAS 41 considers the classification of biological assets and how their characteristics, and hence value, change over time. The standard applies to agricultural produce up to the point of harvest, after which IAS 2, *Inventories* is applicable. A distinction is made between the two because IAS 41 applies to biological assets throughout their lives but to agricultural produce only at the point of harvest.

IAS 41 includes a table of examples which clearly sets out three distinct stages involved in the production of biological assets. For example, we can identify dairy cattle as the biological asset, milk as the agricultural produce and cheese as the product that is processed after the point of harvest.

Calves and cows are biological assets as they are living animals whereas beef and milk are agricultural produce.

Agricultural activities may be quite diverse, but all such activities have similar characteristics as described below.

Common characteristics of agricultural activities

- **Capacity to change** – living animals and plants are capable of changing. For example, a sapling grows into a fruit tree which will bear fruit and a sheep can give birth to a lamb;
- **Management of change** – the biological transformation relies on some form of management input, ensuring, for example, the right nutrient levels for plants, providing the right amount of light or assisting fertilisation; and
- **Measurement of change** – the changes as a result of the biological transformation are measured and monitored. Measurement is in relation to both quality and quantity.

Context example: Common characteristics of agricultural activities

An entity is involved in the production and sale of raw materials for food products, in the sale of fish reared at its own 'fish farms' and in the sale of fish caught in the Northern seas by ocean-going trawlers. An analysis of the processes involved is as follows.

Food products raw materials

The entity owns farmland on which it grows annual crops of corn for sale to food manufacturers. The growing process is aided by the careful application of a range of nutrients, while additives are administered to the underlying land immediately after harvesting has ended. This is an agricultural activity; the corn growing each year is the biological transformation; growth is encouraged by management's activities and the change is monitored, to identify the time at which harvest should commence.

Fish farming

The entity leases a number of privately-owned lakes into which it puts underwater tanks for the rearing of fish. This is an agricultural activity, because the fish are grown to the size suitable for sale and their feed must be provided for them since the amount available naturally in the tanks will be insufficient.

Ocean fishing

The entity owns a number of trawlers. The trawlers go to sea in search of suitable fish. This is not an agricultural activity. Although there is biological transformation on the part of the fish, there is no management intervention in the process; neither is there any routine measurement of the amount of any change which has taken place. The trawlers harvest what the seas yield naturally.

3.1.1 Bearer biological assets

An amendment was issued to IAS 41 in 2014 regarding plant-based bearer biological assets, which would include trees grown in plantations, such as grape vines, rubber trees and oil palms.

These plants are used solely to grow crops over several periods and are not in themselves consumed. When no longer productive they are usually scrapped.

It was decided that fair value was not an appropriate measurement for these assets as, once they reach maturity, the only economic benefit they produce comes from the agricultural produce they create. In this respect, they are similar to assets in a manufacturing activity.

Consequently, these assets have been removed from the scope of IAS 41 and should be accounted for under IAS 16, *Property, Plant and Equipment*. They are measured at accumulated cost until maturity and are then subject to depreciation and impairment charges. The IAS 16 revaluation model could also be applied. Agricultural produce from these plants continues to be recognised under IAS 41.

Interactive question 12: Classification

Into which category would the following items be classified according to IAS 41, *Agriculture*?

12.1 Wool

12.2 Sugar

See **Answer** at the end of this chapter.

3.2 Recognition and measurement

3.2.1 Recognition criteria

A biological asset or agricultural produce should only be recognised when:

- the entity controls the asset as a result of past events, for example the acquisition of dairy cattle. The past event is the purchase, and control is obtained as the entity is now the legal owner;
- it is probable that future economic benefits will flow to the entity, for example because the dairy cattle will produce milk which can be sold or processed into cheese and sold; and
- fair value, or cost, of the asset can be measured reliably.

3.2.2 Measurement of biological assets

A biological asset should initially be measured at its **fair value less estimated costs to sell**, such as duty and commission to brokers or dealers.

Costs to sell

Costs to sell do not include any costs that are necessary to get the asset to a market, for example transport. These should, however, be deducted in determining fair value.

Fair value

Fair value is 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date'.

Where an active market exists for a biological asset the quoted price in the market is the appropriate fair value.

Where an active market does not exist, then fair value may be derived by using:

- the most recent transaction in the market, assuming that similar economic conditions exist at the time of the transaction and at the reporting date;
- market prices for similar assets with appropriate adjustments to reflect differences; and
- sector-based benchmarks, for example the value of meat per kilogram.

IAS 41 includes the presumption that it will be possible to fair value a biological asset. But if fair value cannot be measured reliably at the time of initial recognition then the biological asset should be recognised at cost less accumulated depreciation and impairment cost (i.e., the decrease in the recoverable amount of an asset). Fair value should then be used as soon as a reliable measurement can be made.

At subsequent reporting dates a biological asset should continue to be measured at its fair value. Once a biological asset has been measured at fair value it is not possible to revert to cost.

3.2.3 Measurement of agricultural produce

Agricultural produce should be measured at its fair value, less estimated costs to sell at the point of harvest. Subsequent measurement is by reference to IAS 2. It will always be possible to fair value the agricultural produce since, by its very nature, there must be a market for it.

Interactive question 13: Costs to sell

Which of the following expenses would be classified as costs to sell when valuing biological assets and agricultural produce?

A Commission to brokers

B Transfer taxes and duties

C Transport costs

D Advertising costs

See **Answer** at the end of this chapter.

Worked example: Fair value

An entity rears animals to be sold in a local market. The market is 50 km away, and transport to market costs £1 per animal. At the measurement date the open market value is £60. The auctioneers charge a sales commission of 2% of market value and there is a government levy, based on market value, of 1% on purchases and 3% on sales.

Requirement

How should the fair value less cost to sell be calculated?

Solution

The fair value less costs to sell is calculated as:

	£
Market value	60.00
Transport to market costs	(1.00)
Fair value	59.00
Costs to sell	
Auctioneers' commission – 2% of £60	(1.20)
	£
Government levy – 3% of £60	(1.80)
Fair value less costs to sell	56.00

3.2.4 Grouping assets

Grouping biological assets, or agricultural produce, according to significant attributes, such as age or quality, may help to establish fair value. Such groupings should be consistent with attribute groupings that are used in the market as a basis for pricing, for example, by wine vintage.

Some biological assets are physically attached to land, for example tree plantations, and it is necessary to value the land and biological assets together as one asset, even though agricultural land is not within the scope of IAS 41. To obtain the fair value of the biological assets, the fair value of the land element should be deducted from the combined fair value.

Land is dealt with under IAS 16 or IAS 40.

3.3 Gains and losses

Gains or losses arising on the initial recognition at fair value of a biological asset and agricultural produce should be reported directly in profit or loss for the period to which they relate, for example a gain may arise on the birth of a calf. Subsequent changes in the fair value will also be reported directly in profit or loss.

Gains or losses on the initial recognition of agricultural produce should also be included in profit or loss in the period in which they arise. Such gains or losses may arise as a result of harvesting, because the harvested crop may be worth more than the unharvested crop. In this case a gain would arise.

Worked example: Changes in fair value

A herd of five four-year old animals was held on 1 January 20X3. On 1 July 20X3, a 4.5-year old animal was purchased. The fair values less estimated costs to sell were as follows.

4. year-old animal at 1 January 20X3	£200
4.5-year-old animal at 1 July 20X3	£212
5. year-old animal at 31 December 20X3	£230

Requirement

Show the reconciliation of the changes in fair value.

Solution

The movement in the fair value less estimated costs to sell of the herd can be reconciled as follows.

	£
At 1 January 20X3 (5 × £200)	1,000
Purchased	212
Change in fair value (the balancing figure)	168
At 31 December 20X3 (6 × £230)	1,380

The entity is encouraged to disclose separately the amount of the change in fair value less estimated costs to sell arising from physical changes and price changes.

If it is not possible to measure biological assets reliably and they are instead recognised at their cost less depreciation and impairment an explanation should be provided of why it was not possible to establish fair value. A full reconciliation of movements in the net cost should be presented with an explanation of the depreciation rate and method used.

4 IFRS 6, *Exploration for and Evaluation of Mineral Resources*

Section overview

IFRS 6, *Exploration for and Evaluation of Mineral Resources* has been effective since 2006 and essentially deals with two matters.

- Allows entities to use existing accounting policies for exploration and evaluation assets.
- Requires entities to assess exploration and evaluation assets for impairment. The recognition criteria for impairment are different from IAS 36 but, once impairment is recognised, the measurement criteria are the same as for IAS 36.

4.1 Scope

The standard deals with the accounting of expenditures on the exploration for and evaluation of mineral resources (that is, minerals such as gold, copper, etc, oil, natural gas and similar resources), except:

- expenditures incurred before the acquisition of legal rights to explore; and
- expenditures incurred following the assessment of technical and commercial feasibility.

IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors* still applies to such industries in helping them determine appropriate accounting policies. Thus, accounting policies must present information that is relevant to the economic decision needs of users. Entities may change their policies under IFRS 6 as long as the new information comes closer to meeting the IAS 8 criterion.

4.2 Measurement at recognition

At recognition, exploration and evaluation assets must be measured at cost.

Entities must determine which expenditures to recognise and **apply their policy consistently**. Such expenditure may include acquisition of rights to explore, exploratory drilling, sampling, studies and activities relating to commercial evaluation.

Expenditure related to the **development of mineral resources** is outside the scope of IFRS 6. This comes under IAS 38.

4.3 Measurement after recognition

Entities must apply either the **cost model** or the **revaluation model** in IAS 16.

4.4 Changes in accounting policies

These may be made if the change makes the financial statements more relevant to users. IAS 8 criteria need to be applied.

4.5 Classification and reclassification

Exploration and evaluation assets are classified as **tangible or intangible according to the nature** of the assets acquired. The classification must be applied consistently. They should no longer be classified as such when the technical feasibility and commercial viability of extracting a mineral resource are demonstrable.

4.6 Impairment

The difficulty with respect to exploratory activities is that future economic benefits are generally very uncertain and hence forecasting future cash flows, for example, is difficult. IFRS 6 modifies IAS 36 to state that impairment tests are required:

- When the technical and commercial viability of extraction is demonstrable, at which point IFRS 6 is no longer relevant to the asset.
- When other facts indicate that the carrying amount exceeds recoverable amounts, such as:
  - exploration rights have expired;
  - substantive expenditure on further exploration for and evaluation of mineral resources in the specific area is neither budgeted nor planned;
  - there has been no success in finding commercially viable mineral resources and the entity has decided to discontinue exploratory activities within a specific area; and
  - estimates suggest that the carrying amounts of assets are unlikely to be recovered in full following successful development of the mineral resource.

In such circumstances, impairment is undertaken in accordance with IAS 36.

4.7 Presentation and disclosure

Exploration and evaluation assets are recorded as tangible or intangible assets, as appropriate. Once benefits are demonstrable, assets dealt with under IFRS 6 are superseded by other appropriate standards and are reclassified accordingly.

Disclosure relates to the following:

- A description of the accounting policies applied
- The amounts relating to assets, liabilities, income and expense, and operating and investing cash flows arising from exploration for and evaluation of mineral resources

5 IFRS 4, *Insurance Contracts*

Section overview

IFRS 4 represents interim guidance, as the first phase of a bigger project on insurance contracts. The objective of IFRS 4 is to make limited improvements to accounting practices for insurance contracts and to require an issuer of insurance contracts to disclose information that identifies and explains amounts arising from such contracts.

5.1 Background

IFRS 4 specifies the financial reporting for insurance contracts by any entity that issues such contracts, or holds reinsurance contracts. It does not apply to other assets and liabilities held by insurers.

In the past there was a wide range of accounting practices used for insurance contracts and the practices adopted often differ from those used in other sectors. As a result the IASB embarked on a substantial project to address the issues surrounding the accounting for insurance contracts. Rather than issuing one standard that covered all areas, the IASB decided to tackle the project in two phases.

Interim guidance has been issued in phase one of the project in the form of IFRS 4; it is a stepping stone to the second phase of the project. IFRS 4 largely focuses on improving the disclosure requirements in relation to insurance contracts; however, it also includes a number of limited improvements to existing accounting requirements.

Although IFRS 4 sets out a number of accounting principles as essentially best practice, it does not require an entity to use these if it currently adopts different accounting practices. An insurance entity is however prohibited from changing its current accounting policies to a number of specifically identified practices.

5.2 What is an insurance contract?

Definition

Insurance contract: A contract between two parties, where one party, the insurer, agrees to compensate the other party, the policyholder, if it is adversely affected by an uncertain future event.

An uncertain future event exists where at least one of the following is uncertain at the inception of an insurance contract:

- the occurrence of an insured event;
- the timing of the event; or
- the level of compensation that will be paid by the insurer if the event occurs (IFRS 4 Appendix B).

Some insurance contracts may offer **payments-in-kind** rather than **compensation** payable to the policyholder directly. For example, an insurance repair contract may pay for a washing machine to be repaired if it breaks down; the contract will not necessarily pay monetary compensation.

In identifying an insurance contract it is important to make the distinction between **financial risk** and **insurance risk**. A contract that exposes the issuer to financial risk without significant insurance risk does not meet the definition of an insurance contract.

Financial risk is where there is a possible change in a financial or non-financial variable, for example a specified interest rate, commodity prices, an entity's credit rating or foreign exchange rates.

Definition

Insurance risk: A risk that is not a financial risk. The risk in an insurance contract is whether an event will occur (rather than arising from a change in something), for example a theft, damage against property, or product or professional liability.

Examples of insurance contracts

Appendix B to IFRS 4, which forms an integral part of the standard, includes an extensive list of examples of insurance contracts including:

- life insurance and prepaid funeral plans. It is the timing of the event that is uncertain here, for example certain life cover plans only pay out if death occurs within a specified period of time;
- disability and medical cover;
- credit insurance, covering the policyholder for non-recoverable receivables; and
- travel cover to provide against any loss suffered while travelling.

Examples of an insurer taking on insurance risk are as follows:

- An insurance contract issued to a policyholder against the escalation of claims from faulty motorcycles. The fault was discovered a year ago and the extent of total claims is yet to be established. This is an insurance contract since the insured event is the discovery of the ultimate cost of the claims.
- A gas boiler repair service available from a supplier who, for the payment of a fixed fee, will fix the malfunctioning boiler. This is an insurance contract as it is a payment-in-kind contract, with the uncertain event being whether the boiler will break down and the policyholder will be adversely affected.

Examples which are not insurance contracts

It is important to distinguish between **insurance contracts** and **other contracts** that are not covered by IFRS 4 but which might look like insurance contracts. To provide clarification IFRS 4 specifically identifies a number of areas where its provisions do not apply, for example:

- the provision of product warranties given directly by the manufacturer, dealer or retailer;
- employers' assets and liabilities in relation to employee benefit plans and obligations under a defined benefit plan;
- a contractual right, or obligation, that is contingent on the right to use a non-financial item, for example some licences;

- a lease that contains a residual value guaranteed by the lessee, ie, a specified value for the asset at the end of the lease is guaranteed by the lessee;
- financial guarantees within the scope of IFRS 9, *Financial Instruments;*
- contingent consideration that has arisen as a result of a business combination; and
- insurance contracts that the entity holds as policyholder.

5.3 Recognition and measurement

IFRS 4 exempts an insurer temporarily (during phase one of the IASB's insurance project) from the need to consider the IASB *Framework* in selecting accounting policies for insurance contracts where there is no specific accounting requirement set out in another international Standard (IFRS 4.13, through its reference to IAS 8, *Accounting Policies*, *Changes in Accounting Estimates and Errors)*.

However, IFRS 4 expressly:

- requires a test for the adequacy of recognised insurance liabilities – referred to as the **liability adequacy test**;
- prohibits provisions for possible claims under contracts that are not in existence at the reporting date (referred to as catastrophe or equalisation provisions);
- requires an impairment test for reinsurance assets. An impairment is only recognised where after the commencement of a reinsurance contract, an event has occurred that will lead to amounts due under the contract not being recovered in full, and a reliable estimate of the shortfall can be assessed; and
- requires an insurer to continue to recognise insurance liabilities in its financial statements until they are discharged, cancelled or expire, and to present such liabilities without offsetting them against related reinsurance assets.

Liability adequacy test

An insurer recognises its insurance liabilities at each reporting date based on the current estimate of future contractual cash flows, and related items such as handling costs, arising under the insurance contracts.

This provision should be reassessed at each reporting date and any identified shortfall should be recognised immediately as part of profit or loss for the period. This is the so called **liability adequacy test**.

The assessment should be based on current estimates for future cash flows under the insurance contracts issued. If the recognised insurance liability is assessed as being adequate, then IFRS 4 does not require any further action by the insurer. However, if the liability is found to be inadequate, then the entire shortfall should be recognised in profit or loss.

The liability adequacy test considers all contractual cash flows under current insurance contracts, and related costs, such as claims handling costs. Where there are embedded options or guarantees within a contract, any cash flows arising should also be included in the assessment. Where an entity has deferred acquisition costs and related intangible assets, such as those arising from an insurance based business combination these should be deducted from the insurance liabilities.

If the accounting policies of an insurer do not demand that a liability adequacy test should be carried out, as described above, then an assessment is still required of the potential net liability (ie, the relevant insurance liabilities less any related deferred acquisition costs). In these circumstances the insurer is required to recognise at least the amount that would be required to be recognised as a provision under the application of IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

That is, if the carrying amount of the IAS 37 calculated provision is greater than that recognised, then the insurer should increase the liabilities as appropriate.

Context example: Liability adequacy test

An insurance entity writes one-year policies for one of its classes of general insurance business and is carrying the following amounts for that class in its draft statement of financial position at 31 December 20X5.

	£m
Liabilities	
Provision for claims – discounted value of likely claims for insured losses occurring up to 31 December 20X5	75
Liability for unearned premiums – proportion of premiums for policies already written which relates to cover in 20X6	30
Assets	
Deferred acquisition costs – proportion of commission and other business acquisition costs for policies already written which relate to the unearned premiums	10

The effect of reinsurance is immaterial.

The entity's procedure for calculating the provision for claims is as follows.

(a) To use past experience to make a range of estimates of amounts ultimately payable to insured persons in respect of claims for losses occurring by the reporting date and of the timing of the payments

(b) To select the most likely amount and timing as its central estimate

(c) To discount the amount by reference to a risk-free rate

(d) To use past experience to increase the discounted amount by a risk margin to reflect the inherent uncertainty in this discounted estimate

(e) To increase the adjusted amount by an estimate, based on past experience and discounted, of the internal costs (such as employee benefits and accommodation costs) which will be incurred in handling the loss claims over the period up to their settlement

The cost of the provision is recognised in profit or loss. As this procedure meets the requirements of IFRS 4 no further action is necessary.

The entity also estimates on a similar basis the discounted total amount, including claims handling costs, which will be payable in respect of insured losses arising after the reporting date over the period of cover which generates the unearned premiums. The estimated amount is £25 million.

As all the policies extend for one year, in 20X6 the whole of the £30 million unearned premiums will become earned. But in 20X6 the deferred acquisition costs of £10 million will be charged against those premiums. Against this net income of £20 million, the estimated cost of claims is £25 million. Hence, there is a premium deficiency of £5 million in 20X6, which should be recognised in profit or loss in 20X5.

5.4 Disclosures

IFRS 4 sets out an overriding requirement that the information to be disclosed in the financial statements of an insurer "helps users understand the amounts in the insurer's financial statements that arise from insurance contracts" (IFRS 4: para 4.36).

This information should include the accounting policies adopted and the identification of recognised assets, liabilities, income and expense arising from insurance contracts.

More generally, the risk management objectives and policies of an entity should be disclosed, since this will explain how an insurer deals with the uncertainty it is exposed to.

An entity is not generally required to comply with the disclosure requirements in IFRS 4 for comparative information that relates to annual periods beginning before 1 January 2005. However, comparative disclosure is required in relation to accounting policies adopted and the identification of recognised assets, liabilities, income and expense arising from insurance contracts.

5.5 Current developments: IFRS 17

5.5.1 Background

IFRS 4 was criticised for allowing a large number of different accounting policies, resulting in a lack of comparability, even within insurance groups. To address this the IASB has developed a new standard, IFRS 17, *Insurance Contracts*.

Adoption of IFRS 17 is mandatory for reporting periods beginning on or after 1 January 2023. Early adoption is permitted. In addition insurance companies are permitted to delay initial adoption of IFRS 9 (see Chapter 16) until IFRS 17 is applied.

> **Tutorial note**
>
> IFRS 4 is still the examinable standard, so an overview of the main features of IFRS 17 is required, bearing in mind that companies may early adopt.

IFRS 17 was published in 2017 and introduces a comprehensive financial reporting framework for insurance contracts which aims to achieve greater comparability and consistency in financial reporting by insurers.

5.5.2 Scope

The scope of IFRS 17 is similar to IFRS 4 and encompasses insurance contracts issued, reinsurance contracts both issued and held and investment contracts with discretionary participation features if issued by insurers.

5.5.3 Simplified measurement model

A simplified measurement model referred to as the premium allocation approach can be used for short term insurance contracts and is similar to the use of an unearned premium reserve under IFRS 4.

5.5.4 General measurement model

The general measurement method is more complex and will be applied to long-term insurance contracts. It uses a building block approach to establish the value of insurance contracts on initial recognition.

This general method discounts future cash flows related to the contract and adjusts for non-financial risk to arrive at the value of fulfilment cash flows. To these is added an equal and opposite amount representing the unearned profit over the contract life, referred to as contractual service margin.

Insurance contracts are remeasured at each subsequent year end and a proportion of contractual service margin is released to profit or loss as part of the insurance service result.

Contracts for which the value of fulfilment cash flows is negative (liability) are referred to as onerous contracts. This amount is not mirrored in the creation of a contractual service margin, but rather is recognised immediately in profit or loss.

In practice the measurement models of IFRS 17 will generally be applied to groups of contracts with similar characteristics aggregated together rather than on an individual contract basis.

5.5.5 Reinsurance contracts

The measurement of reinsurance contracts follows the same measurement principles and mirrors that of the primary insurance contract(s) to which it is related.

5.5.6 Implementation challenges

The implementation of such a significant change to the financial reporting of insurance contract is likely to represent a significant systems challenge to insurers and auditors will need to perform additional work in relation to these systems and the related internal controls. Implementing IFRS 17 is likely to be a complex, lengthy process, with the following implications:

(a) Changes to profit recognition patterns

(b) Increased volatility of profit and equity

(c) Increased options and requirement for judgement

Set against this, it can be argued that the changes will bring greater transparency through disclosure.

6 Audit focus points

Section overview

The audit of investment properties should focus on:

- whether the property has been correctly classified;
- whether the valuation is materially correct (either under the cost model or the FV model); and
- whether the disclosure complies with IAS 40/IFRS 13.

Other areas will have been tested at the Professional Level in Audit and Assurance but may still require some key questions to be answered by auditors in the Corporate Reporting exam.

6.1 General approach to auditing assets

You should be familiar with the auditing of tangible and intangible assets from the Certificate Level Assurance exam. If you do not feel confident in this area, we would recommend that you revise it.

Your earlier studies should give you a good understanding of the audit techniques, and the sources of audit evidence, that an auditor can use in a range of different scenarios. Your knowledge of the financial reporting standards will inform your specific approach in the exam. For example:

- testing for tangible non-current assets should consider both over- and under-statement, as well as valuation and impairment
- intangible assets can vary significantly, but in most cases, the auditor is on the lookout for creative accounting and instances where expenditure might not be recognised when it should be, leading to overstated assets and understated expenses

- inventory is usually going to be a material balance, so auditors must concentrate on the two key issues of quantity (using the inventory count) and valuation (lower of cost and net realisable value)

6.2 Auditing investment properties

Definition

Investment property: Property (land or a building – or part of a building – or both) held (by the owner or by the entity as a right-of-use asset) to earn rentals or for capital appreciation or both, rather than for:

- use in the production or supply of goods or services or for administrative purposes; or
- sale in the ordinary course of business.

The following would be non-investment properties:

- Property held for sale in the ordinary course of business
- Property being constructed or developed on behalf of third parties
- Owner-occupied property

Investment property is initially measured at its **cost** (including transaction costs and directly attributable expenditure). After recognition it is measured at **either depreciated cost or fair value**.

Audit evidence

Issue	Evidence
Classification as an investment property	Confirm that all investment properties are classified in accordance with the IAS 40 definition. This will include: • a building owned by the entity and leased out under one or more operating leases; and • a building that is vacant but is held to be leased under one or more operating leases.
	Verify rental agreements, ensuring that the occupier is not a connected company and that the rent has been negotiated at arm's length If the building has recently been built, check the architect's certificates to ensure that cost/fair value is reasonable
Valuation	If cost model adopted, check compliance with IAS 16. If fair value model adopted: • Check that fair value has been measured in accordance with IFRS 13 • Where current prices in an active market are not available confirm that alternative valuation basis is reasonable and in accordance with IFRS 13, and document the relevant audit evidence • Agree valuation to valuer's certificate • Recalculate gain or loss on change in fair value and agree to amount in statement of profit or loss and other comprehensive income • If fair value cannot be measured reliably confirm use of cost model • Consider the use of an auditor's expert to review the appropriateness of the underlying market assumptions and valuation methodology used

Issue	Evidence
Disclosure	Confirm compliance with IAS 40/IFRS 13, for example: • Disclosure of policy adopted • If fair value model adopted disclosure of a reconciliation of carrying amounts of investment property at the beginning and end of the period • Disclosure of the inputs used to measure fair value based on the fair value hierarchy (Level 1, Level 2 or Level 3) • Where Level 2 or Level 3 inputs are used, a description of the valuation techniques and inputs used (interest rates, net reversionary yield, stabilised net rental value, costs to complete and developer's profit) • For fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss and other comprehensive income for the period

Note: IAS 40 states that fair value should be measured in accordance with IFRS 13.

Interactive question 14: Investment property and fair value

Propertyco, an investment property company, has a portfolio of properties, including the following:

Property A	This is used as the company head office.
Property B	This is held as a right-of-use asset and is currently rented out to a non-group company under an operating lease.
Property C	This was acquired in the year at a cost of £3 million including legal fees. It is currently vacant but a tenant is being actively sought.
Property D	This has been owned by Propertyco for a number of years and is currently rented out to a non-group company.

Propertyco uses the fair value model in accordance with IAS 40. Currently all the above properties are recorded in the financial statements at fair value.

Requirements

Based on the information above:

(a) Identify the audit issues which the auditor would need to consider

(b) List the audit procedures you would perform regarding fair values

See **Answer** at the end of this chapter.

Context example: Big Yellow Group plc

Deloitte, the statutory auditor of the Big Yellow Group plc – the self-storage solutions business listed on the FTSE 250 – noted in the auditor's report in the group's financial statements for the year ended 31 March 2015 that investment properties constituted an area of particular audit risk. The nature of the risk and the auditor's responses to the risk were described in the following except from the auditor's report. The full annual report can be found at the following URL: http://html.investis.com/B/Big-yellow-plc/reports/ar2015/pdfs/Big_Yellow_AR2015.pdf

Risk

At 31 March 2015, the Group held wholly owned investment properties and investment properties under construction valued at £1,022.8 million.

Investment properties are held at fair value on the balance sheet. The net valuation gain, relating to Group held properties was £64.5 million, which was recognised through the Consolidated Income Statement during the year. The fair values at 31 March 2015 are calculated using actual and forecast inputs, such as occupancy, capitalisation rates, an assessment of cost to complete for investment properties under construction and net rent per square foot by property. In addition, the valuers apply professional judgement concerning market conditions and factors impacting individual properties.

The valuation process is inherently judgemental, which is why we consider this to be a risk of material misstatement. In particular, changes in assumptions such as the capitalisation rates, forecast rent per square foot, forecast occupancy levels and, in the case of investment property under construction, cost to complete can lead to significant movements in the value of the property, as can changes in the underlying market conditions.

How the scope of our audit responded to the risk

(a) We assessed the design and implementation of controls around the property valuations by considering the level of management oversight and review of the valuations prepared by the external valuation specialists engaged by management, who have been named in note 14;

(b) We tested the integrity of the information provided by management to the valuers by agreeing key inputs such as actual occupancy and net rent per square foot to underlying records and source evidence;

(c) We modelled eight years of valuations and key valuation inputs to the investment property portfolio, to understand the historical trends of key inputs and compared these against the key forecast assumptions included in the property valuation;

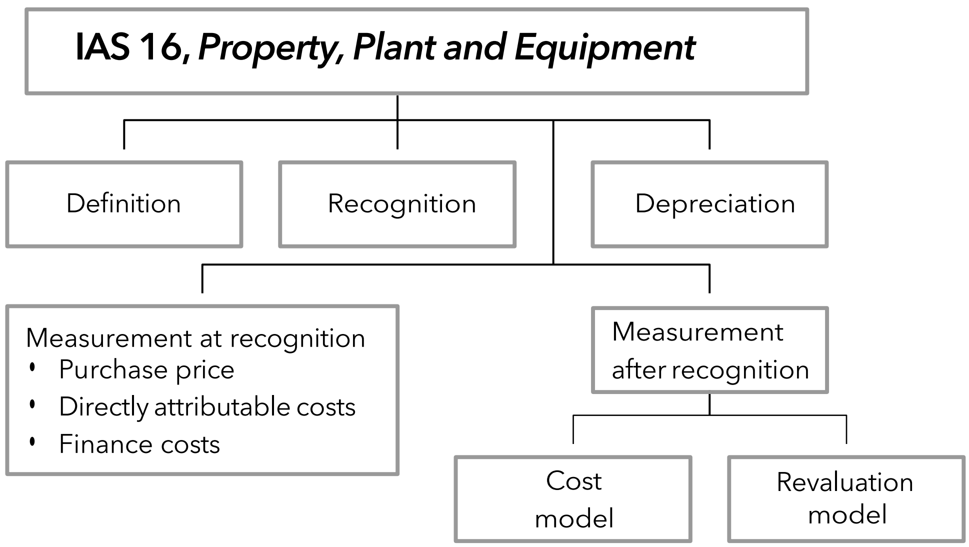
(d) We met with the valuers. We assessed their independence, the scope of the work they were requested to perform by management, and the valuation methodology applied. For each property we identified as having significant or unusual valuation movements (compared to market data or previous periods), we challenged the valuers on the key assumptions applied. Our challenge was informed by input from our internal valuation specialists, utilising their knowledge and expertise in the market at a macro level and the relevant geographies to challenge the key judgemental inputs noted adjacent. We also researched comparable transactions and understood trends in analogous industries. We understood the rationale for outlying valuations or movements and obtained corroborative evidence. We also assessed the valuations for a sample of other properties; and

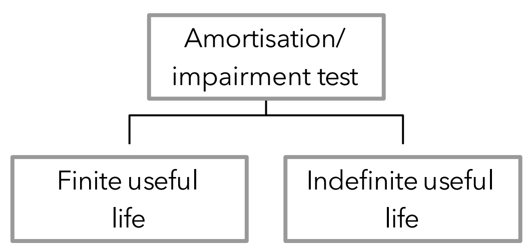
(e) We visited a sample of properties to assess the condition of the buildings.

Professional skills focus: Concluding, recommending and communicating

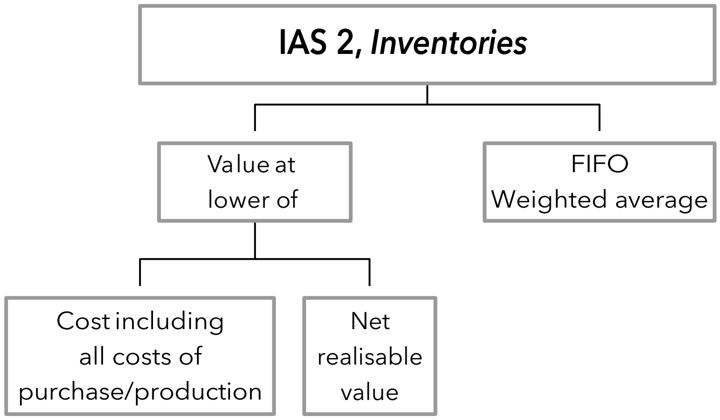
Investment property can be risky and subject to judgement on the part of valuers. Effective communication on the part of the auditors is therefore particularly important. The above case study shows the auditors acting with professional scepticism while maintaining sufficient trust to elicit the necessary information.

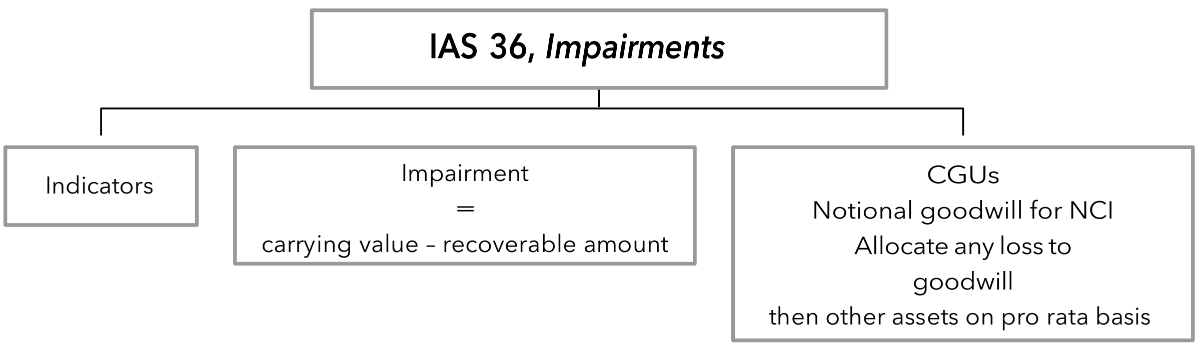
Summary

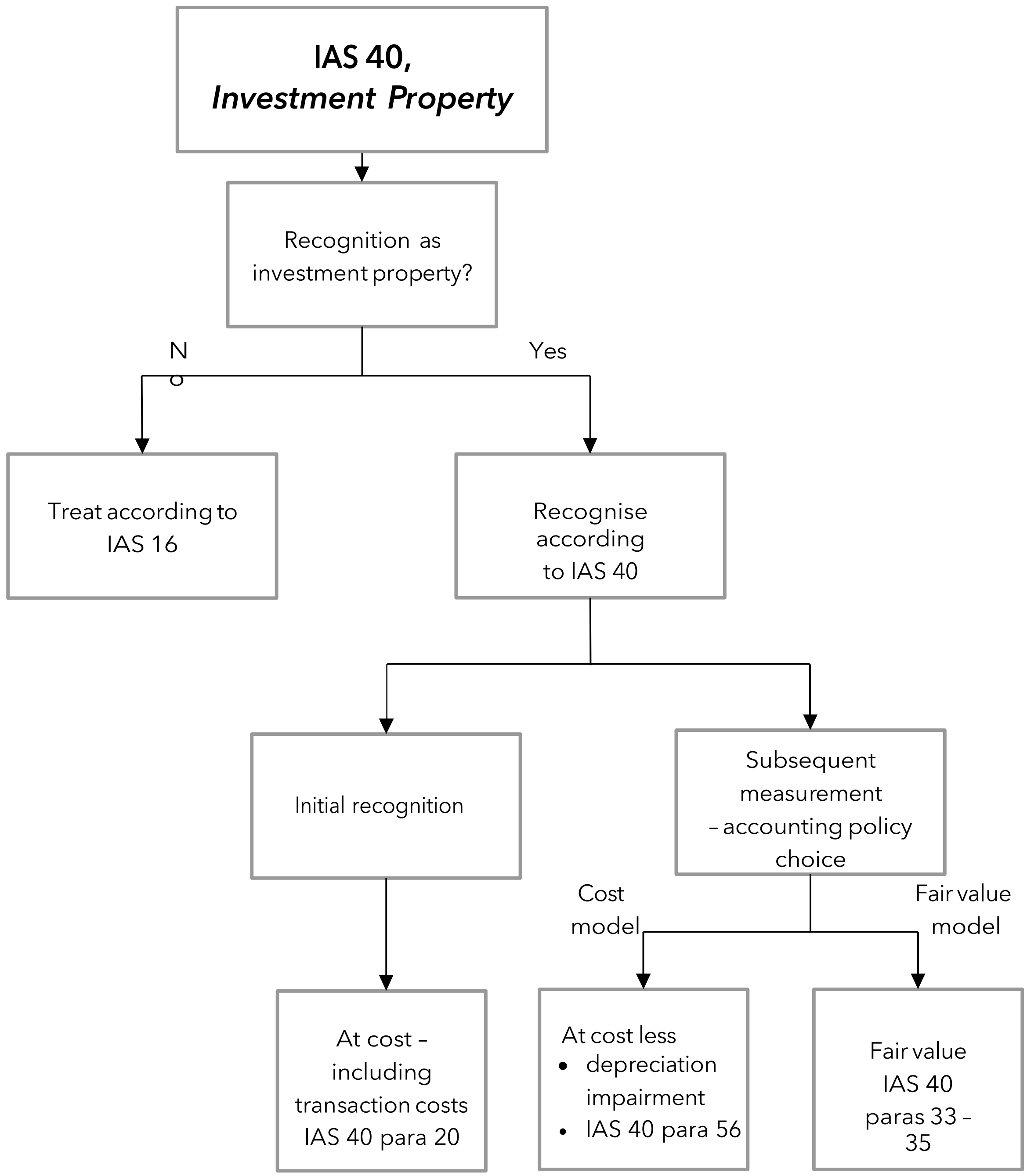

IAS 16, *Property, Plant and Equipment*
Definition
Recognition
Depreciation
Measurement at recognition
• Purchase price
• Directly attributable costs
• Finance costs
Measurement after recognition
Cost model
Revaluation model

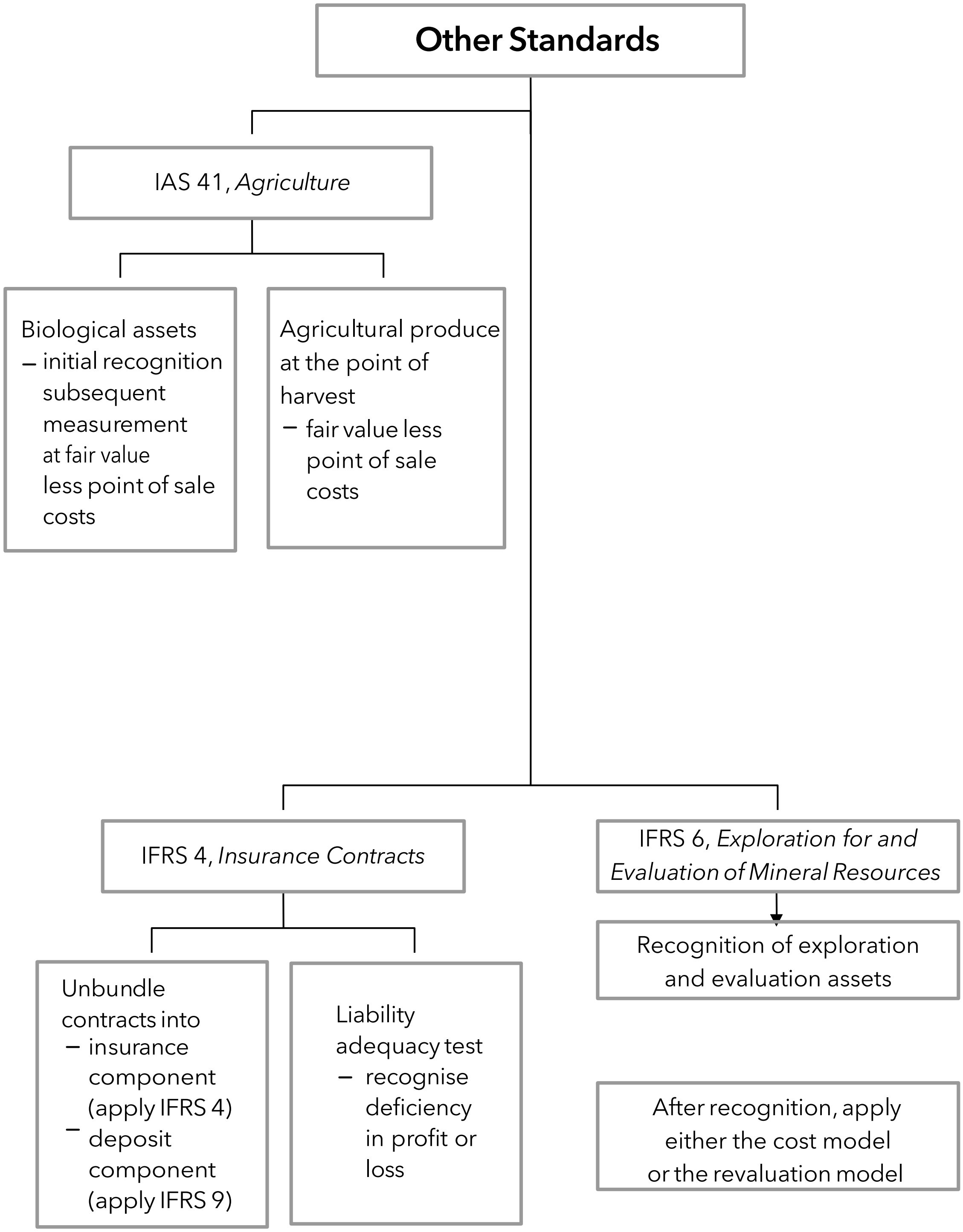

Amortisation/ impairment test
Finite useful life
Indefinite useful life


Separate acquisition
Acquired in business combination
Acquisition by way of a government grant
Exchanges of assets
Internally generated goodwill
Internally generated intangibles


IAS 2, *Inventories*
Value at lower of
FIFO
Weighted average
Cost including all costs of purchase/production
Net realisable value


IAS 36, *Impairments*
Indicators
Impairment
=
carrying value – recoverable amount
CGUs
Notional goodwill for NCI
Allocate any loss to goodwill
then other assets on pro rata basis


IAS 40,
Investment Property
Recognition as investment property?
No
Yes
Treat according to IAS 16
Recognise according to IAS 40
Initial recognition
Subsequent measurement – accounting policy choice
Cost model
Fair value model
At cost – including transaction costs IAS 40 para 20
At cost less
• depreciation impairment
• IAS 40 para 56
Fair value IAS 40 paras 33 – 35


Other Standards
IAS 41, *Agriculture*
Biological assets
– initial recognition subsequent measurement at fair value less point of sale costs
Agricultural produce at the point of harvest
– fair value less point of sale costs
IFRS 4, *Insurance Contracts*
Unbundle contracts into
– insurance component (apply IFRS 4)
– deposit component (apply IFRS 9)
Liability adequacy test
– recognise deficiency in profit or loss
IFRS 6, *Exploration for and Evaluation of Mineral Resources*
Recognition of exploration and evaluation assets
After recognition, apply either the cost model or the revaluation model

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Can you list the key points in IAS 36, *Impairment of Assets*? (Topic 1)
2.	How should change in use be dealt with under IAS 40? (Topic 2)
3.	How should biological assets be measured under IAS 41? (Topic 3)
4.	How should exploration and evaluation assets be measured under IFRS 5? (Topic 4)
5.	What should be the auditor's main focus when auditing investment properties? (Topic 6)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Ruapehu	You should have no trouble with this quick revision of inventory from your earlier studies.
Oruatua	This is on PPE, and is rather more complex than you will have met in your earlier studies.
Acetone	This tests impairment of goodwill, including 'notional' goodwill, which you may have found tricky in your Professional Level studies.
Ramshead	Investment property is new at Advanced Level, so you need a substantial question to get you started. This one tests the interaction of IAS 40 with IFRS 5, which you covered in an earlier chapter.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted the self-test questions, you can continue your studies by moving onto the next chapter. In later chapters, we will recommend questions from the Question Bank for you to attempt.

Technical reference

1 **IAS 16, *Property, Plant and Equipment***

- Recognition – **IAS 16.7**
- Initial costs – **IAS 16.11**
- Subsequent costs – **IAS 16.12**
- Measurement at recognition – **IAS 16.15**
- Measurement after recognition – **IAS 16.29**
- Derecognition – **IAS 16.67-72**
- Disclosure – **IAS 16.73-79**

2 **IAS 38, *Intangible Assets***

- Scope – **IAS 38.2**
- Definition – **IAS 38.8**
- Intangible assets – **IAS 38.9-10**
- Identifiability – **IAS 38.11-12**
- Control – **IAS 38.13**
- Future economic benefits – **IAS 38.17**
- Recognition and measurement – **IAS 38.18-67**
- Recognition of an expense – **IAS 38.68**
- Measurement after recognition – **IAS 38.72**
- Cost model – **IAS 38.74**
- Revaluation model – **IAS 38.75-87**
- Useful life – **IAS 38.88-96**
- Intangible assets with finite useful lives – **IAS 38.97-106**
- Intangible assets with indefinite useful lives – **IAS 38.107-110**
- Recoverability of the carrying amount - impairment losses – **IAS 38.111**
- Retirements and disposals – **IAS 38.112**
- Disclosure – **IAS 38.118**

3 **IAS 2, *Inventories***

- Measurement and disclosure but not recognition – **IAS 2.1**
- Measured at lower of cost and net realisable value – **IAS 2.9**
- Cost = expenditure incurred, in bringing the items to their present location and condition, so the cost of purchase and the cost of conversion – **IAS 2.10**
  - Fixed costs included by reference to normal levels of activity – **IAS 2.13**
- Cost formula: FIFO or Weighted average – **IAS 2.25**
- NRV includes costs to complete and selling costs – **IAS 2.6**
- Disclosures include accounting policies, carrying amounts and amounts recognised as an expense – **IAS 2.36-38**

4 IAS 36, *Impairment of Assets*

(1) **Indications**

- At each reporting date assess whether indication of impairment: – **IAS 36.9**
  - If so, estimate recoverable amount (RA)
  - RA is higher of fair value less costs to sell and value in use (present value of future cash flows in use and on disposal) – **IAS 36.6**
  - Review both external and internal information for evidence of impairment – **IAS 36.12**
- Impairment loss where carrying amount exceeds RA – **IAS 36.59**

(2) **Fair value less costs to sell**

- The way in which fair value is determined depends on whether there is a binding sale agreement and/or an active market – **IAS 36.25-27**
- Examples of disposal costs – **IAS 36.28**

(3) **Value in use**

- Calculation involves the estimation of future cash flows as follows: – **IAS 36.39**
  - Cash flows from continuing use
  - Cash flows necessarily incurred to generate cash inflows from continuing use
  - Net cash flows receivable/payable on disposal
- These should reflect the current condition of the asset – **IAS 36.44**
- The discount rate should reflect:
  - The time value of money – **IAS 36.55**
  - Risks specific to the asset for which the future cash flow estimates have not been adjusted

(4) **Cash-generating units**

- Estimate recoverable amount of CGU if not possible to assess for an individual asset – **IAS 36.66**
- Identification of an asset's CGU involves judgement – **IAS 36.68**
- Goodwill should be allocated to each of the acquirer's CGUs that are expected to benefit – **IAS 36.80**
- Goodwill that cannot be allocated to a CGU on a non-arbitrary basis is allocated to the group of CGUs to which it relates – **IAS 36.81**
- Annual impairment review required for any CGU which includes goodwill – **IAS 36.90**
- Corporate assets should be allocated on a reasonable and consistent basis – **IAS 36.102**

(5) **Impairment losses**

- If the asset is held under the cost model the impairment should be recognised in profit or loss – **IAS 36.60**
- If the asset has been revalued the impairment loss is treated as a revaluation decrease – **IAS 36.60**
- An impairment loss for a CGU should be allocated: – **IAS 36.104**
  - To goodwill then
  - To all other assets on a pro rata basis
- When a CGU is a non-wholly owned subsidiary and non-controlling interest is measured at acquisition date at share of net assets, notionally gross up goodwill for that part attributable to the non-controlling interest – **IAS 36 (Appendix C)**

(6) **Reversals**

- An impairment loss recognised for goodwill should not be reversed – **IAS 36.124**

(7) **Disclosures**

- All impairments – **IAS 36.126**
- For a material impairment on an individual asset – **IAS 36.130**
- For a material impairment on a CGU – **IAS 36.130**

5 IAS 40, *Investment Property*

- Definition of investment property – **IAS 40.5**
- Definition of fair value – **IFRS 13.9**
- Property held as a right-of-use asset may be investment property – **IAS 40.6**
- Fair value model – **IAS 40.33-35, IAS 40.38**
- Cost model – **IAS 40.56**

6 IAS 41, *Agriculture*

- Scope – **IAS 41.1**
- Agricultural activities – **IAS 41.5, 8**
  - Biological assets
  - Agricultural produce at the point of harvest
  - Government grants
- Recognition and measurement – **IAS 41.10, 12-13**
- Gains and losses – **IAS 41.26, 28**
- Government grants – **IAS 41.34-35**
- Disclosure – **IAS 41.40, 41, 46-50, 54-57**

7 IFRS 6, *Exploration for and Evaluation of Mineral Resources*

- Scope – **IFRS 6.3-5**
- Measurement at recognition – **IFRS 6.8-11**
- Measurement after recognition – **IFRS 6.12**
- Changes in accounting policies – **IFRS 6.13**
- Impairment – **IFRS 6.18**

8 IFRS 4, *Insurance Contracts*

- Objective – **IFRS 4.1**
- Scope – **IFRS 4.2-6**
- Embedded derivatives – **IFRS 4.7-9**
- Liability adequacy test – **IFRS 4.15**

Self-test questions

Answer the following questions

1 **IAS 40**

Which of the following properties fall under the definition of investment property and therefore within the scope of IAS 40, *Investment Property*?

A Property occupied by an employee paying market rent

B A building owned by an entity and leased out under an operating lease

C Property being constructed on behalf of third parties

D Land held for long-term capital appreciation

2 **Ruapehu**

The Ruapehu Company manufactures a single type of concrete mixing machine, which it sells to building companies. Ruapehu is currently considering the value of its inventories at 31 December 20X7. The following data are relevant at this date:

	Cost per item £
Variable production costs	200,000
Fixed production costs	40,000
	240,000

There are 85 mixing machines held in inventory.

The company has a contract to sell 15 concrete mixing machines at £225,000 each to a major local building company in January 20X8. The normal selling price is £260,000 per machine. Selling costs are minimal.

Requirement

What is the value of Ruapehu's inventory at 31 December 20X7, according to IAS 2, *Inventories*?

3 **Utah**

The Utah Company manufactures motors for domestic refrigerators. A major customer is The Bushbaby Company, which is a major international electrical company making refrigerators as one of its products.

Utah is currently preparing its financial statements for the year to 31 December 20X7 and it expects to authorise them for issue on 3 March 20X8.

Utah holds significant inventories of motors (which are unique to the Bushbaby contract) as Bushbaby requires them to be supplied on a just-in-time basis and has variable production schedules.

On 3 January 20X8, Bushbaby announced that it was fundamentally changing the design of its refrigerators and that, while this had been planned for some time, it had not been possible to warn Utah for reasons of commercial confidentiality. As a consequence, it would cease to use Utah's motors from 30 April 20X8 and would reduce production before that date. Details for Utah are as follows:

Number of motors held in inventory at 31 December	4,000 motors
Expected sales in the four months to 30 April 20X8	1,600 motors
Net selling price per motor sold to Bushbaby	£50
Net selling price per motor unsold at 30 April 20X8	£10
Cost per motor	£25

Requirement

At what value should the inventories of motors be stated by Utah in its statement of financial position at 31 December 20X7 according to IAS 2, *Inventories*, and IAS 10, *Events after the Reporting Period*?

4 Niobium

The Niobium Company operates in the petrol refining industry. A fire at a competitor using similar plant has revealed a safety problem and the Government has introduced new regulations requiring the installation of new safety equipment in the industry. The refinery had a carrying amount of £30 million before the installation of the safety equipment. The new safety equipment cost £5 million and was fully operational at 31 December 20X7, but it does not generate any future economic benefits. The refinery would, however, be closed down without such equipment being installed.

At 31 December 20X7 the net selling price of the refinery was estimated at £33 million. In determining its value in use, the directors have determined that the refinery would generate annual cash flows of £3.2 million from next year in perpetuity, to be discounted at 10% per annum.

Requirement

According to IAS 16, *Property, Plant and Equipment*, what is the carrying amount of the refinery in Niobium's statement of financial position at 31 December 20X7?

5 Oruatua

The Oruatua Company acquired a piece of machinery for £800,000 on 1 January 20X6. It identified that the asset had three major components as follows:

Component	Useful life	Cost (£'000)
Pump	5 years	110
Filter	4 years	240
Engines	15 years	450

Under the terms of the 15-year licence agreement for the use of the machinery, the engines (but not the other components) were to be dismantled at the end of the licence period. The machinery contained three engines, and dismantling costs for all three engines were initially estimated at a total cost of £480,000 (ie, £160,000 per engine) payable in 15 years' time. Oruatua's discount rate appropriate to the risk specific to this liability is 7% per annum.

One of the three engines developed a fault on 1 January 20X7 and had to be sold for scrap for £40,000. A replacement engine was purchased at a cost of £168,000 on 1 January 20X7, for use until the end of the licence period, when dismantling costs on this engine estimated at £150,000 would be payable.

At a rate of 7% per annum the present value of £1 payable in 15 years' time is 0.3624 and of £1 payable in 14 years' time is 0.3878.

Requirements

Calculate the following figures for inclusion in Oruatua's financial statements for the year ended 31 December 20X7 according to IAS 16, *Property, Plant and Equipment*, and IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

(a) The carrying amount of the machinery at 31 December 20X6;

(b) The profit/loss on the disposal of the faulty engine;

(c) The carrying amount of the machinery at 31 December 20X7.

6 Antimony

The Antimony Company acquired its head office on 1 January 20W8 at a cost of £5.0 million (excluding land). Antimony's policy is to depreciate property on a straight-line basis over 50 years with a zero residual value.

On 31 December 20X2 (after five years of ownership) Antimony revalued the non-land element of its head office to £8.0 million. Antimony does not transfer annual amounts out of revaluation reserves as assets are used: this is in accordance with the permitted treatment in IAS 16, *Property, Plant and Equipment*.

In January 20X8, localised flooding occurred and the recoverable amount of the non-land element of the head office property fell to £2.9 million.

Requirement

What impairment charge should be recognised in the profit or loss of Antimony arising from the impairment review in January 20X8 according to IAS 36, *Impairment of Assets*?

7 Sundew

The Sundew Company is a vertically integrated manufacturer of chainsaws. It has two divisions. Division X manufactures engines, all of which are identical. Division Y assembles complete chainsaws and sells them to third party dealers.

Division X, a cash-generating unit, sells to Division Y at cost price but sells to other chainsaw manufacturers at cost plus 50%. Details of Division X's budgeted revenues for the year ending 31 December 20X7 are as follows:

	Engines	Price per engine
Sales to Division Y	2,500	£1,000
Third party sales	1,500	£1,500

Requirement

What are the 20X7 cash inflows which should be used in determining the value in use of Division X according to IAS 36, *Impairment of Assets*?

8 Cowbird

The Cowbird Company operates in the television industry. It acquired a licence to operate in a particular region for 20 years at a cost of £10 million on 31 December 20X3. Cowbird's policy was to amortise the fee paid for the licence on a straight-line basis.

By 31 December 20X5 it had become apparent that Cowbird had overpaid for the licence and, measuring recoverable amount by reference to value in use, it recognised an impairment charge of
£4.05 million, leaving a carrying amount of £4.95 million.

At 31 December 20X7 the market place had improved, such that the conditions giving rise to the original impairment no longer existed. The recoverable amount of the licence by reference to value in use was now £11 million.

Requirement

What should be the carrying amount of the licence in the statement of financial position of Cowbird at 31 December 20X7, according to IAS 36, *Impairment of Assets*?

9 Acetone

The Acetone Company is testing for impairment two subsidiaries which have been identified as separate cash-generating units.

Some years ago, Acetone acquired 80% of The Dushanbe Company for £600,000 when the fair value of Dushanbe's identifiable assets was £400,000. As Dushanbe's policy is to distribute all profits by way of dividend, the fair value of its identifiable net assets remained at £400,000 on 31 December 20X7. The impairment review indicated Dushanbe's recoverable amount at 31 December 20X7 to be
£520,000.

Some years ago Acetone acquired 85% of The Maclulich Company for £800,000 when the fair value of Maclulich's identifiable net assets was £700,000. Goodwill of £205,000 (£800,000 – (£700,000 × 85%)) was recognised. As Maclulich's policy is to distribute all profits by way of dividend, the fair value of its identifiable net assets remained at £700,000 on 31 December 20X7. The impairment review indicated Maclulich's recoverable amount at 31 December 20X7 to be £660,000.

It is Acetone group policy to value the non-controlling interest using the proportion of net assets method.

Requirements

Determine the following amounts in respect of Acetone's consolidated financial statements at 31 December 20X7 according to IAS 36, *Impairment of Assets*.

(a) The carrying amount of Dushanbe's assets to be compared with its recoverable amount for impairment testing purposes.

(b) The carrying amount of goodwill in respect of Dushanbe after the recognition of any impairment loss.

(c) The carrying amount of the non-controlling interest in Maclulich after recognition of any impairment loss.

10 Titanium

On 1 January 20X7 The Titanium Company acquired the copyright to four similar magazines, each with a remaining legal copyright period for 10 years. At the end of the legal copyright period, other publishing companies will be allowed to tender for the copyright renewal rights.

At 31 December 20X7 the following information was available in respect of the assets:

Publication name	Copyright cost at 1 January 20X7	Remaining period over which publication is expected to generate cash flows at 1 January 20X7	Value in active market at 31 December 20X7
Dominoes	£900,000	6 years	£700,000
Billiards	£1,200,000	16 years	£1,150,000
Skittles	£1,700,000	8 years	Unknown
Darts	£1,400,000	Indefinite	£2,100,000

Titanium uses the revaluation model as its accounting policy in relation to intangible assets.

Requirement

What is the total charge to profit or loss for the year ended 31 December 20X7 in respect of these intangible assets per IAS 38, *Intangible Assets*?

11 Lewis

The following issues have arisen in relation to business combinations undertaken by the Lewis Company.

(1) Lewis acquired the trademark of a type of wine when it acquired 80% of the ordinary share capital of The Calcium Company on 1 April 20X7. This wine is produced from a vineyard that is exclusively used by Calcium.

(2) When Lewis bought a football club on 1 May 20X7, it acquired the registrations of a group of football players.

(3) Lewis acquired a 75% share in the Stilt Company during 20X7. At the acquisition date Stilt was researching a new pharmaceutical product which is expected to produce future economic benefits.

The cost of these assets can be measured reliably.

Requirement

Indicate which of the above items should or should not be recognised as assets separable from goodwill in Lewis's statement of financial position at 31 December 20X7, according to IAS 38, *Intangible Assets*.

12 Diversified group

The following issues have arisen within a diversified group of businesses.

(1) The Thrasher Company has signed a three-year contract with a team of experts to write questions for a computer based examination on International Financial Reporting Standards. The contract states that the experts cannot work on similar projects for rival entities. Thrasher incurred costs of £5,000 in training the experts to use the software, and believes that the product developed by the team will be a market leader.

(2) The Curium Company has a loyalty card scheme for customers. Every customer purchase is recorded in such a way that Curium is able to create a profile of spending amounts and habits of customers, and uses this to target them with special offers and discounts to encourage repeat business. The database has cost £60,000 to create and Curium has been approached by another company wishing to buy the contents of the database.

Requirement

Which of the above items should be classified as intangible assets per IAS 38, *Intangible Assets*?

13 Cadmium

The Cadmium Company produces a globally recognised dog food that is a market leader. The trademark was established over 50 years ago and is renewable every eight years. The last renewal was effective from 1 January 20X2 and cost £65,000. Cadmium intends to continue to renew the trademark in future years.

Cadmium uses the revaluation model where allowed for measuring intangible assets, in accordance with IAS 38, *Intangible Assets*. A valuation of £50 million was made by an independent valuation expert on 31 December 20X7, who charged £650,000 for the valuation report.

Requirement

What is the carrying amount of the trademark in Cadmium's statement of financial position at 31 December 20X7 per IAS 38, *Intangible Assets*?

14 Piperazine

The Piperazine Company's financial reporting year ends on 31 December. It has adopted the revaluation model for intangible assets and revalues them on a regular three-year cycle. For intangibles with a finite life Piperazine transfers the relevant amount from revaluation reserve to retained earnings each year.

During 20X4 Piperazine incurred £70,000 on the process of preparing an application for licences for 15 taxis to operate in a holiday resort where, in order to prevent excessive traffic pollution, the licensing authority only allowed a small number of taxis to operate. The outcome of its application was uncertain up to 30 November 20X4 when the local authority accepted its application. In December 20X4 Piperazine incurred a total cost of £9,000 in registering its licences. The licences were for a period of nine years from 1 January 20X5. The licences are freely transferable and an active market in them exists. The fair value of the licences at 31 December 20X4 was £9,450 per taxi and Piperazine carried them at fair value in its statement of financial position at 31 December 20X4.

At 31 December 20X7, Piperazine undertook its regular revaluation. On that date the licensing authority announced that it would triple the number of licences offered to taxi operators and there were transactions in the active market for licences with six years to run at £4,500.

Requirements

Determine the following amounts in respect of the revaluation reserve in respect of these taxi licences in Piperazine's financial statements according to IAS 38, *Intangible Assets*.

14.1 The balance at 31 December 20X4

14.2 The balance at 31 December 20X7 before the regular revaluation

14.3 The balance at 31 December 20X7 after the regular revaluation

15 Boron

The Boron Company is an investment property company. On 31 December 20X6, it purchased a retirement home as an investment at a cost of £600,000. Legal costs associated with the acquisition of this property were a further £50,000.

At 31 December 20X7 Boron adopted the fair value model. The fair value of the retirement home at this date was £700,000 and costs to sell were estimated at £40,000.

Requirement

What amount should appear in the statement of profit or loss and other comprehensive income of Boron in the year ending 31 December 20X7 in respect of the retirement home under IAS 40, *Investment Property*?

16 Laburnum

The Laburnum Company is an investment property company. One of its properties is a warehouse which has the specialist use of storing tropical plants at high temperatures. As a result, the central heating system is an important and integral part of the warehouse building. Laburnum uses the fair value model for investment properties.

The central heating system was purchased on 1 January 20X2 for £80,000. It is being depreciated at 10% per annum on cost and it has been agreed by the valuer that the carrying amount of the central heating system is a reasonable value at which to include it in the fair value of the entire warehouse.

In December 20X7, the valuer initially determined the fair value of the warehouse, including the central heating system, to be £1,250,000. Unfortunately, the central heating system completely failed on 25 December 20X7 and was immediately scrapped and replaced with a new heating system costing £140,000 on 31 December 20X7.

Requirement

According to IAS 40, *Investment Property*, at what value should the warehouse, including the heating system, be recognised in the financial statements of Laburnum in the year ending 31 December 20X7?

17 Ramshead

On 1 January 20X6, The Ramshead Company acquired an investment property for which it paid £3.1 million and incurred £100,000 agency and legal costs. The property's useful life was estimated at 20 years, with no residual value; its fair value at 31 December 20X6 was estimated at £3.45 million and agency and legal costs to dispose of the property at that date were estimated at £167,500.

On 1 July 20X7, Ramshead decided to dispose of the property. The criteria for being classified as held for sale were met on that date, when the property's fair value was £3.5 million. Agency and legal costs to dispose of the property were estimated at £160,000.

On 1 October 20X7, the property was sold for a gross price of £3.7 million, with agency and legal costs of £165,000 being incurred.

Requirements

Calculate the following amounts in respect of Ramshead's financial statements for the year ended 31 December 20X7 in accordance with IAS 40, *Investment Property* and IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*.

17.1 The gain or loss arising in 20X6 from the change in carrying amount if the fair value model is used to account for the property

17.2 The gain or loss on disposal arising in 20X7 if the cost model is used

17.3 The increase or decrease, compared with the cost model, in the gain or loss on disposal arising in 20X7 if the fair value model is used

18 Arapawanui

The Arapawanui Company keeps a flock of sheep on its land, selling the milk outputs to make cheese. The day after its production, the milk is collected on behalf of the purchasers and revenue from its sale is recognised.

On 30 June 20X7 300 animals were born, all of which survived and were still owned by Arapawanui at 31 December 20X7. 10,000 litres of milk were produced in the year to 31 December 20X7.

The following market data is available in respect of the sheep.

Type of animal	At 30 June 20X7 Fair value per animal	At 31 December 20X7 Fair value per animal
	£	£
Newborn	22	23
6 months old	25	26

The animal fair values are based on transactions prices in the local markets. Auctioneers' commission is 1.5% of the transaction price and the government sales levy is 0.5% of that price.

The production cost, including overheads, of the milk was £0.08 per litre and the fair values were £0.13 per litre throughout 20X7 and £0.14 per litre throughout 20X8. Costs to sell were estimated at 4%.

Requirement

What gain should be recognised in respect of the newborn sheep and the milk in Arapawanui's financial statements for the year to 31 December 20X7, according to IAS 41, *Agriculture*?

19 Tepev

The Tepev Company bought a flock of 400 sheep on 1 December 20X7. The cost of each sheep was
£80, which represented fair value at that date. Auctioneers' fees on sale are 5% of fair value, and the cost of transporting each sheep to market is £4.00. An agricultural levy of £2.00 is payable on each sheep sold.

At 31 December 20X7 all of the sheep are still held and fair value has increased to £90 per sheep. No other costs have changed. Tepev has a contract to sell the sheep on 31 March 20X8 for £100 each.

Requirement

What is the carrying amount of the flock in the statement of financial position at 31 December 20X7, according to IAS 41, *Agriculture*?

20 Saving

The Saving Company bought a flock of 500 sheep on 1 December 20X7. The cost of each sheep was
£95, which represented fair value at that date. Auctioneers' fees on sale are 5% of fair value, and the cost of transporting each sheep to market is £3.00. An agricultural levy of £2.00 is payable on each sheep sold.

At 31 December 20X7 all of the sheep are still held and fair value has increased to £107 per sheep. No other costs have changed. Saving has a contract to sell the sheep on 31 March 20X8 for £119 each.

Requirement

What is the gain arising in relation to the flock between the date of initial recognition as an asset and 31 December 20X7, according to IAS 41, *Agriculture*?

21 Monkey

The Monkey Company has the following information in relation to a cattle herd in the year ended 31 December 20X7.

	£'000
Cost of herd acquired on 1 January 20X7 (which equates to fair value)	1,800
Auctioneers' sales fees	2% of sale price
Loan obtained at 8% to finance acquisition of herd	1,500
Fair value of herd at 31 December 20X7	2,500
Transport cost to market	35
Government transfer fee on sales – no fee on purchases	50

Requirement

What is the loss arising on initial recognition of the herd as biological assets and the gain arising on its subsequent remeasurement under IAS 41, *Agriculture*, in the year ended 31 December 20X7?

22 Blackbuck

The Blackbuck Company has in issue unit-linked contracts which pay benefits measured by reference to the fair value of the pool of investments supporting the contracts. The terms of the contracts include the following.

(1) On surrender by the holder or on maturity, the benefits shall be the full fair value of the relevant proportion of the investment.

(2) In the event of the holder's death before surrender or maturity, the benefits shall be 120% of the full value of the relevant proportion of the investments.

Blackbuck's accounting policies do not otherwise require it to recognise all the obligations under any deposit component within these contracts.

Blackbuck's financial controller is unclear whether these contracts should be accounted for under IFRS 4, *Insurance Contracts*, or under IFRS 9, *Financial Instruments*.

Requirement

Explain how these contracts should be accounted for.

23 Traore

The Traore Company is organised into a number of divisions operating in different sectors. The accounting policies applied in two of its divisions before the introduction of IFRS 4, *Insurance Contracts* are as follows.

Accounting policy (1)	In its car breakdown division, Traore offers unlimited amounts of roadside assistance in exchange for an annual subscription. Although it has always accepted that this activity is in the nature of offering insurance against breakdown, it accounts for these subscriptions by using the stage of completion method under IAS 18, *Revenue,* and making relevant provisions for fulfilment costs under IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.
Accounting policy (2)	In its property structures insurance division, Traore makes a detailed estimate for the cost of each outstanding claim but adopts the practice of adding another 20% to the total on a 'just in case' basis.

Requirement

Which of these accounting policies is Traore permitted to continue to use under IFRS 4, *Insurance Contracts*?

24 Evaluation and exploration

Give examples of circumstances that would trigger a need to test an evaluation and exploration asset for impairment.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

1.1 The double entry is:

DEBIT	Asset value (statement of financial position)		£7,000
CREDIT	Profit or loss		£2,000
CREDIT	Revaluation surplus (other comprehensive income)		£5,000

The case is similar for a **decrease in value** on revaluation. Any decrease should be recognised as an expense, except where it offsets a previous increase taken as a revaluation surplus in other comprehensive income. Any decrease greater than the previous upwards increase in value must be recorded as an expense in profit or loss.

1.2 The double entry is:

DEBIT	Revaluation surplus (other comprehensive income)	£5,000	
DEBIT	Profit or loss	£2,000	
CREDIT	Asset value (statement of financial position)		£7,000

There is a further complication when a **revalued asset is being depreciated**. An upward revaluation means that the depreciation charge will increase. Normally, a revaluation surplus is only realised when the asset is sold, but when it is being depreciated, part of that surplus is being realised as the asset is used. The amount of the surplus realised is the difference between depreciation charged on the revalued amount and the (lower) depreciation which would have been charged on the asset's original cost. **This amount can be transferred to retained (ie, realised) earnings but not through profit or loss**.

1.3 On 1 January 20X8 the carrying value of the asset is £10,000 – (2 × £10,000 ÷ 5) = £6,000. For the revaluation:

DEBIT	Asset value (statement of financial position)	£6,000	
CREDIT	Revaluation surplus (other comprehensive income)		£6,000

The depreciation for the next three years will be £12,000 ÷ 3 = £4,000 compared to depreciation on cost of £10,000 ÷ 5 = £2,000. Each year the extra £2,000 is treated as realised and transferred to retained earnings:

DEBIT	Revaluation surplus	£2,000	
CREDIT	Retained earnings		£2,000

This is a movement within reserves, not an item in profit or loss.

Answer to Interactive question 2

The fair value less costs to sell of the plant is below its carrying value so it may be impaired. It is now necessary to find the value in use in order to determine whether an impairment has occurred and to quantify any impairment loss.

Year	Future cash flows	PV factor at 15%	Discounted future cash flows
	£'000		£'000
1	230	0.86957	200
2	211	0.75614	160

Year	Future cash flows	PV factor at 15%	Discounted future cash flows
	£'000		£'000
3	157	0.65752	103
4	104	0.57175	59
5	233	0.49718	116
			638

To calculate the impairment loss, compare the carrying value of £749,000 with the higher of value in use (£638,000) and fair value less costs to sell (£550,000). The impairment loss is therefore £749,000 – £638,000 = £111,000.

Answer to Interactive question 3

The key issue is whether the cash-generating unit produces cash flows which are independent of other assets or not.

The CGUs which appear to have cash flows independent of the other assets (and can therefore be subject to reliable assessment of their recoverable value) are:

(2) a branch of a pizza restaurant in Warsaw; and

(4) a commuter monorail.

Options (1) and (3) are not generators of independent cash flows and are therefore too small to be CGUs in their own right. In the case of (3) the CGU is the theme park as one entity.

Additionally (5) is a CGU in its own right as there is an external active market for its services, even though these are not openly available (IAS 36.71).

Answer to Interactive question 4

In both scenarios:

	(1)	(2)
	£m	£m
Recognised goodwill	90	90
Notional goodwill (£90m × 40/60)	60	60
Carrying amount of net assets	550	550
	700	700
Recoverable amount	510	570
Impairment loss	190	130
Allocation of impairment loss:		
	£m	£m
Recognised goodwill	90	90
Notional goodwill	60	40
Other assets pro rata	40	
	190	130

Carrying value after impairment:

	£m	£m
Goodwill (90 – (150 × 60%))/(90 – (130 × 60%))	–	12
Other net assets (550 – 40)	510	550
	510	562

Answer to Interactive question 5

For each scenario:

(1) The factory is not an investment property. It should be classified as property held for sale and accounted for under IFRS 5.

(2) The building would qualify as an investment property under IAS 40, as the entity intends to earn rentals from it under an operating lease.

(3) The provisions offered over and above the office space itself fall within what IAS 40 describes as 'ancillary services'. Considering the nature and extent of these services, it would be unlikely that they could be described as 'insignificant' in relation to the arrangements as a whole. The building is, in essence, being used for the provision of serviced offices and therefore does not meet the definition of an investment property.

Although the entity's main objective in acquiring the building is its potential capital appreciation, the building should be recognised and measured in accordance with IAS 16 rather than IAS 40.

(4) The property should be recognised as an investment property on 30 March 20X5 when the offices were ready to be occupied. Costs incurred, and consequently operating losses, after this date should be expensed even though the entity did not start to receive rentals until later in 20X5. Losses incurred during this 'empty' period are part of the entity's normal business operations and do not form part of the cost of the investment property.

Answer to Interactive question 6

6.1 The £5 million value could be used as a basis of fair value, because the price was agreed between market participants.

6.2 The £6 million value could not be used as a basis of fair value, because the sale transaction cannot be presumed to be between market participants in an orderly transaction.

6.3 The £4.5 million value could not be used as a basis of fair value, because the sale transaction would appear to have been made by a forced, not willing, seller, and therefore not an orderly transaction.

6.4 The £5.5 million value could not be used as a basis of fair value, because the sale transaction would appear to have been made to a buyer who was not knowledgeable of local market conditions, and therefore not a market participant in an orderly transaction.

Answer to Interactive question 7

Profit or loss on disposal

The cost model	**£m**
Net proceeds	6.00
Carrying amount £5,500,000 × 47/50	(5.17)
Profit on sale	0.83

The fair value model	**£m**
Net proceeds	6.0
Fair value	(6.2)
Loss on sale	(0.2)

Answer to Interactive question 8

(a) The changes of use will be reflected in the financial statements based on whether the entity uses the cost model or the fair value model for investment properties as follows.

The cost model for investment properties

At 31 December 20X5, the building has a carrying amount of:

£5.5m × 45/50 years = £4.95 million in accordance with IAS 16.

On 1 January 20X6 the property will be recognised as an investment property at its IAS 16 carrying amount of £4.95 million and will continue to be depreciated over its remaining 45-year life.

At 31 December 20Y0, the building has a carrying amount of:

£4.95m × 40/45 years = £4.4 million in accordance with IAS 40.

On 1 January 20Y1 the property will be recognised as property, plant and equipment at its IAS 40 carrying amount of £4.4 million and will continue to be depreciated over its remaining 40- year life.

(b) **The fair value model for investment properties**

At 31 December 20X5, the building has a carrying amount of £4.95 million in accordance with IAS 16 (as set out above).

On 1 January 20X6, the property will be recognised as an investment property. However, the property should be revalued to fair value at 31 December 20X5, and any change in value should be recognised in accordance with IAS 16.

The property will therefore be recognised at a carrying amount of £6 million and the difference of £1.05 million should be recognised as a revaluation surplus (other comprehensive income).

During the period between 1 January 20X6 and 31 December 20Y0 the building is measured at fair value with any gain or loss recognised directly in profit or loss. At the end of 20Y0 the cumulative gain is £1.5 million.

At 31 December 20Y0, the building has a carrying amount of £7.5 million being its fair value and this is the amount that should be recognised as its carrying amount under IAS 16. The carrying amount will be depreciated over the building's remaining 40-year useful life.

Answer to Interactive question 9

£1 million is derecognised being the depreciated cost of the replaced system: £1.2 million × (25/30 years)

£1.2 million is capitalised as the cost of the new system and will be depreciated over its estimated useful life of 10 years.

Answer to Interactive question 10

The carrying amount of the failed system should be derecognised:

Carrying amount is £100,000 (£400,000 less six years' depreciation at 12.5%) The replacement system should be recognised:

Total carrying amount of the office building is £3,500,000 (£3m – £100,000 + £600,000)

Answer to Interactive question 11

The entity recognises these transactions and events as follows.

20X5

The property continues to be measured under the fair value model on classification as held for sale on 30 September. An impairment of £3.65 million is recognised (£4 million less £350,000).

At 31 December the property is presented as held for sale within current assets at £350,000.

20X6

The replacement property is recognised at a cost of £3.8 million and a loss on disposal is recognised of £15,000 being (proceeds of £375,000 less selling costs of £40,000 less carrying amount of property of £350,000).

20X7

The insurance proceeds of £3.9 million are recognised in profit or loss.

Note: The requirement to measure an asset 'held for sale' at the lower of carrying amount and fair value less costs to sell does not apply to investment properties measured at fair value (IFRS 5.5). IAS 40.37 states that costs to sell should not be deducted from fair value.

Answer to Interactive question 12

12.1 Wool: Agricultural produce

12.2 Sugar: Products that are the result of processing after harvest

Answer to Interactive question 13

The correct answers are:

A Commission to brokers

B Transfer taxes and duties

Commissions to brokers and transfer taxes and duties are recognised costs to sell in the standard.

Answer to Interactive question 14

(a) **Audit issues**

(1) **Classification as an investment property**

Property A: As this property is owner occupied it does not fall within the definition of an investment property in accordance with IAS 40 (IAS 40(9)).

Property B: While this property is not legally owned it is held as a right-of-use asset under IFRS 16 and therefore can be treated as an investment property (IAS 40(5)).

Property C: Although this property is currently vacant, on the basis that it is being held for investment purposes it can be classified as an investment property (IAS 40(8d)).

Property D: This is an investment property as it is legally owned by Propertyco and is let out to a non-group company (IAS 40(5)).

(2) **Valuation**

Property A: Should be valued in accordance with IAS 16 ie, cost less accumulated depreciation unless the revaluation model is to be adopted.

Property B: Would have been recognised in accordance with IFRS 16 at the inception of the lease at the present value of the future lease payments, plus payments made at or before commencement less lease incentives. After initial recognition it would be valued at fair value in accordance with company policy in respect of investment properties.

Property C: Should initially be recognised at cost including transaction costs. In this case the asset should initially be recognised at £3 million. As the fair value model is adopted by Propertyco the value will then be revised to fair value.

Property D: Should be recognised at fair value in accordance with IAS 40 and the accounting policy adopted by Propertyco. Changes in fair value should be recognised in profit or loss for the period.

(b) **Audit procedures**

- Evaluate the control environment and the process by which Propertyco establishes fair values.
- Determine the basis on which fair values have been calculated. (In accordance with IAS 40/IFRS 13 this should be the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date.) Current prices per square metre in an active market for similar property in the same location and condition are likely to provide the best evidence or observable market rents. (IAS 40.40 states that the fair value must reflect rental income from current leases and other assumptions that participants would use when pricing investment property under current market conditions).
- Where external valuers have been used assess the extent to which they can be relied on in accordance with the principles of using the work of a management's expert in ISA 500, *Audit Evidence*.
- If fair values have been based on discounted cash flows ie, discounted future rental incomes compare predicted cash flows to current rental agreements and assess whether this is the most appropriate basis for estimating fair value in accordance with IFRS 13. Review the basis on which the interest rate applied has been selected and any other assumptions built into this calculation eg, consider management's history of carrying out its intentions.
- Review any documentation to support assumptions.
- Agree level of disclosure is in accordance with IAS 40/IFRS 13.

Answers to Self-test questions

1 IAS 40

The correct answers are:

A building owned by an entity and leased out under an operating lease D

Land held for long-term capital appreciation

IAS 40.8 and 9 give examples of types of investment property.

2 Ruapehu

£20,175,000

IAS 2.31 requires that NRV should take into account the purpose for which inventory is held. The NRV for the contract is therefore determined separately from the general sales, thus:

	£
Contract: NRV is lower than cost thus use NRV, so (£225,000 × 15) =	3,375,000
General: Use cost as this is less than NRV, so (£240,000 × (85 – 15)) =	16,800,000
	20,175,000

3 Utah

£64,000

IAS 2.30 requires the NRV of inventories to be calculated on the basis of all relevant information, including events after the reporting period. This is supported by the example in IAS 10.9(b).

Thus:

	£
£25 × 1,600 expected to be sold to Bushbaby:	40,000
£10 × 2,400 remainder	24,000
Total	64,000

4 Niobium

£33 million

IAS 16.11 requires the capitalisation of essential safety equipment even if there are no future economic benefits flowing directly from its operation.

It does however subject the total value of all the related assets to an impairment test. In this case the recoverable amount is £33 million, as the net selling price £33 million is greater than the value in use £32 million (ie, £3.2m/0.1). As this is less than the total carrying amount of £35 million (£30m + 5m), the assets are written down to £33 million.

5 Oruatua

(a) £850,355

The initial cost of the asset must include the dismantling cost at its present value, where the time value of the money is material (IAS 16.16(c) and IAS 37.45). The present value of these costs at 1 January 20X6 is £173,952 (£480,000 × 0.3624), making the total cost of the engines £623,952. Each part of the asset that has a cost which is significant in relation to the total asset cost should be depreciated separately (IAS 16.43). Therefore, at the end of 20X6 the carrying amount of the asset is £850,355 (£110,000 × 4/5) + (£240,000 × 3/4) + (£623,952 × 14/15).

(b) £(154,118)

The loss on disposal is (per IAS 16.71) the difference between the carrying amount of an individual engine at 1 January 20X7 of £194,118 (£623,952/3 × 14/15)) and the scrap sale proceeds of £40,000, to give a loss of £154,118.

(c) £756,521

The replacement engine is capitalised at cost of £226,170 (£168,000 + £150,000 × 0.3878), and then depreciated over the remaining length of the licence of 14 years. The carrying amount of the asset at 31 December 20X7 is therefore £756,521 (£110,000 × 3/5) + (£240,000 × 2/4) + (£623,952 × 2/3 × 13/15) + (£226,170 × 13/14).

6 Antimony

£0.7 million

IAS 36.60 and 61 (also IAS 16.40) require that an impairment that reverses a previous revaluation should be recognised through the revaluation reserve to the extent of that reserve. Any remaining amount is recognised through profit or loss. Thus:

- The carrying amount at 31 December 20X2 is 45/50 × £5.0m = £4.5 million.
- The revaluation reserve created is £3.5 million (ie, £8.0m – £4.5m).
- The carrying amount at 31 December 20X7 is 40/45 × £8.0m = £7.1 million.
- The recoverable amount at 31 December 20X7 is £2.9 million.
- The total impairment charge is £4.2 million (ie, £7.1m – £2.9m).
- Of this, £3.5 million is a reversal of the revaluation reserve, so only £0.7 million is recognised through profit or loss.

7 Sundew

£6,000,000

IAS 36.70 requires that in determining value in use where internal transfers are made, then a best estimate should be made of prices that would be paid in an orderly transaction between market participants at the measurement date.

Thus revenues are 4,000 × £1,500 = £6,000,000

8 Cowbird

£8.0 million

IAS 36.110 requires consideration of whether an impairment loss recognised in previous years has reversed or decreased.

IAS 36.117 and 118 restrict the recognition of any such reversal to the value of the carrying amount at the current reporting date had the original impairment not taken place. Thus:

Carrying amount under original conditions = £10m × 16/20 years = £8.0m.

9 Acetone

(a) £750,000

Book value of Dushanbe's net assets	400,000
Goodwill recognised on acquisition	
£600,000 – (80% × £400,000)	280,000
Notional goodwill (£280,000 × 20/80)	70,000
	750,000

(b) £96,000

The impairment loss is the total £750,000 less the recoverable amount of £520,000 = £230,000. Under IAS 36.104 this is firstly allocated against the £350,000 goodwill. (As the impairment loss is less than the goodwill, none is allocated against identifiable net assets.)

As only the goodwill relating to Acetone is recognised, only its 80% share of the impairment loss is recognised:

	£
Carrying value of goodwill	280,000
Impairment (80% × 230,000)	(184,000)
Revised carrying amount of goodwill	96,000

(c) £99,000

	£
Carrying amount of Maclulich's net assets	700,000
Recognised goodwill	205,000
Notional goodwill (15/85 × £205,000)	36,176
	941,176
Recoverable amount	(660,000)
Impairment loss	281,176
Allocated to:	
Recognised and notional goodwill	241,176
Other net assets	40,000

Therefore the non-controlling interest is (£700,000 – £40,000) × 15% = £99,000.

10 Titanium

£672,500

IAS 38.94 deals with the identification of the useful life of an intangible asset arising from legal rights.

The **Dominoes** publication has a useful life of six years, and so should be amortised over this period. At the year end the carrying amount of £750,000, (900,000 × 5/6), exceeds the active market value, so an impairment of £50,000 is required. This gives a total charge of £200,000 (£150,000 amortisation plus £50,000 impairment charge)

The **Billiards** publication is initially amortised over the period of 10 years to the end of the copyright arrangement, as there is no certainty that the company can publish the magazine after this date. This gives a charge of £120,000.

The **Skittles** publication is amortised over the period it is expected to generate cash flows of eight years, giving a charge of £212,500.

The **Darts** publication has an indefinite period over which it is expected to generate cash flows. Under normal circumstances it would be automatically subject to an annual impairment review. However, because the copyright arrangement does have a finite period, amortisation should take place over 10 years, and so a charge of £140,000 is required.

The total charge is £672,500.

11 Lewis

For each statement:

(1) Recognised

The vineyard trademark is not separable because it could only be sold with the vineyard itself. But under IAS 38.36, the combination of the vineyard and the trademark should be recognised.

(2) Recognised

The footballers' registrations represent a legal right which meets the identifiability criterion in IAS 38.12.

(3) Recognised

The research project should be treated as a separate asset, as on a business combination it meets the definition of an asset and is identifiable (IAS 38.34).

12 Diversified group

For each item:

(1) Not an intangible

The training costs would not satisfy the definition of an intangible asset. This is because Thrasher has insufficient control over the expected future benefits of the team of experts (IAS 38.15).

(2) An intangible

The database would be classified as an intangible asset because the willingness of another party to buy the contents provides evidence of a potential exchange transaction for the relationship with customers and that the asset is separable (IAS 38.16).

13 Cadmium

£16,250

The revaluation model cannot be used for this trademark, because for a unique item there cannot be the active market required by IAS 38.75. (A professional valuation does not rank as a value by reference to an active market.) IAS 38.81 requires the cost model to be applied to such an item, even if it is in a class for which the revaluation model is used.

The cost of renewal should be treated as part of the cost of an intangible, under IAS 38.28(b), but the valuation expenses should be charged directly to profit or loss, as administration overheads (IAS 38.29(c)).

The trademark is therefore carried at the cost of renewal, depreciated for six of the eight years' life since last renewal, so £65,000 × 2/8 = £16,250.

14 Piperazine

14.1 £132,750

Under IAS 38.21 the £70,000 spent in 20X4 in applying for the licences must be recognised in profit or loss, because the generation of future economic benefits is not yet probable. The £9,000 incurred in December 20X4 in registering the licences is treated as the cost of the licences because the economic benefits are then probable. The carrying amount of the licences under the revaluation model at 31 December 20X4 is £141,750 (£9,450 × 15), so the balance on the revaluation reserve is the £132,750 uplift (IAS 38.75 & 85).

14.2 £88,500

After three years the accumulated amortisation based on the revalued amount is £47,250 (£141,750 × 3/9), whereas the accumulated amortisation based on the cost would have been £3,000 (£9,000 × 3/9). So £44,250 will have been transferred from the revaluation reserve to retained earnings (IAS 38.87). The remaining balance before the regular revaluation is £88,500 (£132,750 – £44,250).

14.3 £61,500

The carrying amount of the licences immediately before the revaluation is £94,500 (£141,750 – £47,250). The revalued carrying amount is £67,500 (£4,500 × 15). The deficit of £27,000 is recognised in the revaluation reserve, reducing the balance to £61,500 (IAS 38.86).

15 Boron

£50,000

Under the fair value model IAS 40.33 requires investment properties to be measured at fair value, while IAS 40.37 requires fair value to be determined excluding transaction costs that may be incurred on sale or other disposal. IAS 40.35 requires changes in fair value to be recognised in profit or loss.

IAS 40.20 requires transaction costs, such as legal costs, to be included in the initial measurement. So the change in fair value is £700,000 – (£600,000 + £50,000) = £50,000.

16 Laburnum

£1,358,000

IAS 40.19 and 68 require derecognition of the carrying amount of the failed system & inclusion of the replacement.

Thus £1,250,000 – (£80,000 × 4/10) + £140,000 = £1,358,000

17 Ramshead

17.1 £250,000 gain

Transaction costs should be included in the initial measurement of investment properties (IAS 40.20). Under the fair value model an investment property is subsequently carried at fair value without any deduction for costs to sell (IAS 40.33 & 5). The gain recognised in profit or loss is £250,000 (£3.45m – (£3.1m + £0.1m)).

17.2 £575,000 gain

Any asset classified as held for sale is measured in accordance with applicable IFRS immediately before classification. So if the cost model is used, the carrying amount before initial classification is cost less depreciation to the date of classification, so £2.96 million (£3.2m less 18 months' depreciation at 5% per annum). On initial classification, the property is measured at the lower of this carrying amount and the £3.34 million (£3.5m – £160,000) fair value less costs to sell (IFRS 5.15) so £2.96 million. There is no subsequent depreciation (IFRS 5.25), so the carrying amount will be the same at the date of disposal. The profit on disposal is net disposal proceeds less the carrying amount (IAS 40.69), so net sales proceeds of £3.535 million (£3.7m – £165,000) less £2.960 million gives a profit on disposal of £575,000.

17.3 £540,000 decrease

If the fair value model is used, then the carrying amount immediately before initial classification will be the £3.5 million fair value. The requirement to measure an asset 'held for sale' at the lower of carrying amount at fair value less costs to sell does not apply to investment properties measured at fair value (IFRS 5.5) and so the property continues to be measured at fair value. IAS 40.37 states that costs to sell should not be deducted from fair value, so the property continues to be measured at £3.5 million. Profit on disposal will be net sales proceeds of £3.535m less £3.5m = £35,000. This is a reduction of £540,000 on the cost model gain. If the fair value model is used, then the carrying amount immediately before initial classification will be the £3.5 million fair value. The requirement to measure an asset 'held for sale' at the lower of carrying amount at fair value less costs to sell does not apply to investment properties measured at fair value (IFRS 5.5) and so the property continues to be measured at fair value.

IAS 40.37 states that costs to sell should not be deducted from fair value, so the property continues to be measured at £3.5 million. Profit on disposal will be net sales proceeds of £3.535m less £3.5m = £35,000. This is a reduction of £540,000 on the cost model gain.

18 Arapawanui

The newborn sheep are biological assets and should be measured at fair value less costs to sell, both on initial recognition and at each reporting date (IAS 41.12). The gains on initial recognition and from a change in this value should be recognised in profit or loss (IAS 41.26). As the animals are six months old at the year end, the total gain in the year (being the initial gain based on a newborn fair value of £22 plus the year-end change in value by £4 to £26) is £7,644 (300 × £26 × (100% – 1.5% – 0.5%)).

The milk is agricultural produce and should be recognised initially under IAS 41 at fair value less costs to sell (IAS 41.13). (At this point it is taken into inventories and dealt with under IAS 2.) The gain on initial recognition should be recognised in profit or loss (IAS 41.28). The gain is £1,248 (10,000 litres × £0.13 × (100% – 4)).

Total gain is £8,892.

19 Tepev

£33,400

Biological assets should be measured at fair value less costs to sell (IAS 41.12). Costs to sell include sales commission and regulatory levies but exclude transport to market (IAS 41.14). Transport costs are in fact deducted from market value in order to reach fair value. In this question fair value of £90 is provided; it is assumed that this is calculated as a market value of £94 less the quoted transport costs of £4. Contracts to sell agricultural assets at a future date should be ignored (IAS 41.16).

The statement of financial position carrying amount per sheep is:

	£
Fair value	90.00
Costs to sell (£90 × 5%) + £2.00	(6.50)
Value per sheep	83.50

For the flock of 400 sheep, the amount is £33,400.

20 Saving

£5,700

Biological assets should be measured at fair value less costs to sell, both on initial recognition and at each reporting date (IAS 41.12). Costs to sell include sale commission and regulatory levies but exclude transport to market (IAS 41.14). Transport costs are in fact deducted from market value in order to reach fair value. Contracts to sell agricultural assets at a future date should be ignored (IAS 41.16).

	£
FV at reporting date (£107 – commission (£107 × 5%) – levy £2.00)	99.65
Initial FV per sheep (£95 – commission (£95 × 5%) – levy £2.00)	(88.25)
Gain per sheep	11.40

There is, therefore, a gain on the flock of 500 sheep of £5,700.

21 Monkey

£86,000 loss on initial recognition

£686,000 gain on subsequent measurement

	£'000
Cost of herd	1,800
Recognised at FV – costs to sell (£1.8m – fees (£1.8m × 2%) – gvnmt fee £50,000)	(1,714)
Initial loss on recognition	86

On acquisition of the herd, the cattle are initially recognised as biological assets at fair value less costs to sell (IAS 41.27), which in this case is less than cost by the costs to sell which are immediately deducted (IAS 41.27). Acceptable costs to sell include auctioneers' fees and government transfer fees (IAS 41.14) but exclude transport to market costs (IAS 41.14). The interest on the loan taken out to finance the acquisition is not a cost to sell (IAS 41.22).

The value is then restated to fair value less costs to sell at each reporting date (IAS 41.12)

	£'000
Fair value at 31 December 20X7	2,500
Costs to sell: auctioneers fees (£2.5m × 2%)	(50)
Government fees	(50)
Carrying value	2,400
Less initial recognition value	(1,714)
Gain	686

22 Blackbuck

The extra payable on death before surrender/maturity should be accounted for under IFRS 4 and the remainder under IAS 39.

Given the entity's accounting policies in relation to the recognition of obligations under the deposit components, IFRS 4.10 requires the insurance component and the deposit component to be unbundled; IFRS 4.12 requires the insurance component to be accounted for under IFRS 4 and the deposit component under IAS 39.

23 Traore

The entity is permitted to continue with both policies.

IFRS 4.13 disapplies the provisions of IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, in relation to selection of accounting policies where there is no IFRS. Entities are therefore only required to change existing policies in the circumstances listed in IFRS 4.14. Accounting policy (1) is not caught by this paragraph, so its continued use is permitted.

The application of Accounting policy (2) involves the use of excessive prudence. The continued use of excessive prudence is permitted by IFRS 4.26.

24 Evaluation and exploration

Circumstances that would trigger a need to test an evaluation and exploration asset for impairment:

- The expiration or anticipated expiration in the near future of the period for which the entity has the right to explore the relevant area, unless the right is expected to be renewed.
- The lack of available planned or budgeted expenditure for further exploration and evaluation of the specific area.
- A decision to discontinue evaluation activities in the exploration and specific area when commercially viable resources have not been identified.

Chapter 13

Reporting of non-financial liabilities

Introduction

Learning outcomes

- Identify and explain current and emerging issues in corporate reporting
- Explain how different methods of recognising and measuring assets and liabilities can affect reported financial position, and explain the role of data analytics in financial asset and liability valuation
- Explain and appraise accounting standards that relate to assets and non-financial liabilities for example: property, plant and equipment; intangible assets, held-for-sale assets; inventories; investment properties; provisions and contingencies
- Justify and conclude for a particular scenario what comprises sufficient, appropriate audit evidence
- Design and determine audit procedures in a range of circumstances and scenarios, for example identifying an appropriate mix of tests of controls, analytical procedures and tests of details
- Demonstrate and explain, in the application of audit procedures, how relevant ISAs affect audit risk and the evaluation of audit evidence

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
1	**IAS 10, *Events After the Reporting Period*** Regardless of how quickly the financial statements are published after the end of the year, subsequent events and transactions can be so significant that they need to be considered for either disclosure or adjustment or (in extreme situations) for their effect on the underlying principle of going concern. IAS 10, *Events After the Reporting Period*	**Approach** This section should be mainly revision from your earlier studies. Make sure you do all the questions and look back to your earlier studies if you are still unsure. **Stop and think** What type of events could be classified as adjusting or non-adjusting respectively? What type of events could affect the underlying principle of going concern?	Although this standard was tested at Level A at Professional Level, questions at Advanced Level will be more complex and there will be more interaction between standards. Ethical issues may arise, for example if a sale of an asset is treated incorrectly as an adjusting event, rather than non-adjusting, causing revenue and profit to be recognised too early.	**IQ2: Significant events** This short, straightforward question will test whether you have remembered this topic from your earlier studies.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
	deals with the treatment of these issues. You will need to identify the appropriate cut-off date which will depend on the process of authorisation and the reporting entity's jurisdiction.			
2	**IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*** You will be required to identify circumstances in which provisions will be required and when contingent liabilities or contingent assets should be disclosed.	**Approach** The key point is that provisions need to be recognised on the basis of obligations rather than management intentions. **Stop and think** A provision may be required in relation to cyber security breaches.	IAS 37 appears regularly in exam questions within a scenario that tests other standards, for example IAS 19 and IFRS 15. Possible ethical issues may arise, such as the directors wishing to make a lower provision than is required.	**IQ6: Restructuring** This tests IAS 37 in conjunction with IAS 36. **IQ7: Obligation to dismantle** Tests onerous contracts and discounting.
3	**Audit focus** This section focuses on provisions and contingencies, and also covers ISA 501, *Audit Evidence – Specific Considerations for Selected Items* which provides guidance on procedures regarding litigation and claims.	**Approach** The audit focus section will help you with the integrated questions on this area. **Stop and think** Why would the auditors need to communicate with the company's lawyers?	Integrated questions have generally focused on contraventions of IAS 10 and what the auditors should do in such cases.	**IQ8: Contingencies** This is an integrated question with an FR part on disclosures and an audit part on procedures to be carried out to determine whether a company will have to pay damages and if so, how much.

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 IAS 10, *Events After the Reporting Period*

Section overview

- Events after the reporting period are split into adjusting and non-adjusting events. Those events that may affect the going concern assumption underlying the preparation of the financial statements must be considered further.
- The following is a summary of the material covered in earlier studies.

1.1 Overview of earlier studies

Events after the reporting period are split into **adjusting** and **non-adjusting events**.

1.1.1 Adjusting events after the reporting period

Adjusting events are events that provide evidence of conditions that existed at the reporting date, and the financial statements should be adjusted to reflect them. Examples include the following:

- Settlement of a court case that confirms that the entity had an obligation at the reporting date
- Evidence that an asset was impaired at the reporting date eg:
  - Bankruptcy of a customer
  - Selling prices achieved for inventory
- Determination of profit-sharing or bonus payments relating to the year
- Finalisation of prices for assets sold or purchased before year end
- The discovery of fraud or errors (where material) that show that the financial statements are misstated
- An adjustment to the disclosed earnings per share (EPS) for transactions such as bonus issues, share splits or share consolidations where the number of shares altered without an increase in resources. The additional shares are thus treated as having been in issue for the whole period

1.1.2 Non-adjusting events after the reporting period

Non-adjusting events are events that are indicative of conditions that arose after the reporting date. Disclosure should be made in the financial statements where the outcome of a non-adjusting event would influence the economic decisions made by users of the financial statements. Examples are as follows:

- A major business combination after the reporting date (IFRS 3 or the disposing of a major subsidiary)
- Announcement of plan to discontinue an operation
- Major purchases and disposals of assets
- Classification of assets as held for sale
- Expropriation of assets by government
- Destruction of assets, for example by fire or flood
- Announcing or commencing the implementation of a major restructuring
- Major ordinary share transactions (unless these involve transactions such as capitalisation and bonus issues where there is a change in the number of shares without an inflow or

outflow of resources, see adjusting events above. Such transactions require EPS to be restated as if the new number of shares was in issue for the whole year)

- Decline in the market value of investments including investment properties after the reporting date. These should reflect the fair value at the reporting date and should not be affected by hindsight

1.1.3 Going concern basis

Financial statements are prepared on the '**going concern**' basis. Where an entity goes into liquidation after the reporting date, it is no longer considered to be a going concern and the financial statements should not be prepared on this basis.

Where the going concern basis is clearly not appropriate, a basis other than the going concern basis should be adopted, for example the 'break-up basis'. The break-up basis measures the assets at their recoverable amount in a non-trading environment, and a provision is recognised for future costs that will be incurred to 'break-up' the business.

Where the financial statements are not prepared on a going concern basis, this should be fully disclosed, along with the actual basis of preparation used.

Management is required to make an explicit assessment of the entity's ability to continue as a going concern by considering a number of financial, operating and other indicators. Indicative of inability to continue as a going concern would be major restructuring of debt, adverse key financial ratios, substantial sale of non-current assets not intended to be replaced, loss of key staff or major markets.

1.1.4 The period of review

The cut-off date for the consideration of events after the reporting period is the date on which the financial statements are authorised for issue. Events that occur after the reporting date but before the financial statements are authorised for issue need to be considered, regardless of what financial information has been made publicly available during this period.

Normally the financial statements are authorised by the directors before being issued to the shareholders for approval; the authorisation date is the date these are authorised for issue to the shareholders, and not the date they are approved by the shareholders.

Where a supervisory board is made up wholly of non-executive directors, the financial statements will first be authorised by the executive directors for issue to that supervisory board for its approval. The relevant cut-off date for the review of events that have occurred after the reporting date is the date on which the financial statements are authorised for issue to the supervisory board.

The date on which the financial statements were authorised for issue should be disclosed, since events occurring after that date will not be reflected in the financial statements.

1.1.5 Treatment of errors

Errors identified before the authorisation date will be adjusted in the current financial statements. Those identified after the financial statements have been published should be dealt with in a subsequent period under IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*. IAS 8 requires an error relating to a prior period to be treated as an adjustment to the comparative information presented in the subsequent financial statements.

If a significant event occurs after the authorisation of the financial statements but before the annual report is published, the entity is not required to apply the requirements of IAS 10. However, if the event was so material that it affects the entity's business and operations in the future, the entity may wish to discuss the event in the narrative section at the front of the Annual Review but outside the financial statements themselves.

1.1.6 Equity dividends

These should only be recognised as a liability where they have been declared before the reporting date, as this is the date on which the entity has an obligation. Where equity dividends are declared after the reporting date, this fact should be disclosed but no liability recognised at the reporting date.

1.1.7 Further points to note

Information on customers and suppliers

- Information after the reporting date on either a customer or supplier may not only affect amounts that have been recorded in the financial statements but also impact on the future trading of the entity.
- This should be assessed and disclosure made if the liquidation of a major customer or supplier is likely to influence the economic decisions of users of the financial statements.
- Significant customer and supplier relationships are fundamental where an entity relies on one major supplier. An example of a significant supplier/customer relationship is Intel Corporation and Dell Inc, where until recently Dell computers have used only Intel microprocessors. Dell relies almost totally on the ongoing supplier/customer relationship with Intel, and the success of Intel is vitally important to the future trade of Dell itself.

1.1.8 Contingent liabilities

Evidence may come to light regarding a contingent liability or provision that an entity was unaware of at the reporting date. The distinction between a contingent liability and a provision is discussed in IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*. An example of an unknown provision is where, because of a major fault with goods which were purchased before the reporting date, an electrical retail chain has had the goods returned after the reporting date. The fault may raise safety issues and the retailer may have to recall all such items sold within a period of time in order to repair the fault. In such circumstances, a provision should be recognised for the repair of all items that have been sold before the reporting date. The entity may not have been aware of the problem at the reporting date but, as it existed at that date, a provision should be recognised in light of the new information.

Interactive question 1: Various events

The Roach Company is completing the preparation of its draft financial statements for the year ended 31 May 20X6.

On 24 July 20X6, an equity dividend of £200,000 was declared and a contractual profit share payment of £35,000 was made, both based on the profits for the year to 31 May 20X6.

On 20 June 20X6, a customer went into liquidation having owed the company £31,000 for the past six months. No provision had been made against this debt.

On 17 July 20X6, a manufacturing plant was destroyed by fire resulting in a financial loss of £200,000.

Requirement

According to IAS 10, *Events After the Reporting Period*, which amounts should be recognised in Roach's financial statements for the year to 31 May 20X6 to reflect adjusting events after the reporting period?

See **Answer** at the end of this chapter.

Interactive question 2: Significant events

An entity's draft financial statements for the year ended 31 December 20X3 were completed on 30 May 20X4, approved by the finance director on 7 June 20X4, authorised for issue on 20 June 20X4 and approved by the shareholders on 5 July 20X4.

The following events occurred after the reporting date (assume all amounts are significant to the entity):

Requirements

How should the entity treat these events in its financial statements?

(a) Notification on 18 February 20X4 that a customer owing £100,000 as at 31 December 20X3 has gone into liquidation. The financial statements already include a specific provision of £20,000 for this customer and the entity does not make general provisions.

(b) A rights issue on 6 April 20X4 to raise £1,500,000 for an acquisition.

(c) Confirmation on 28 May 20X4 from the entity's insurer that they will pay £500,000 for inventories that were destroyed in a fire on 24 December 20X3. The entity had claimed £650,000 and included this as a receivable in the financial statements.

See **Answer** at the end of this chapter.

Interactive question 3: Dividends proposed and declared

The recent financial calendar of an entity with a 31 December year end has included the following:

	Authorised by directors for issue	Approved in annual general meeting
Financial statements for 20X2	28 February 20X3	3 May 20X3
Financial statements for 20X3	28 February 20X4	4 May 20X4

Dividends on ordinary shares	Proposed by directors	Declared by directors	Approved in annual general meeting
20X2 final	28 Feb 20X3	no	yes
20X3 interim	31 Aug 20X3	yes	no
20X3 final	28 Feb 20X4	no	yes

Requirement

How will the dividends be dealt with in the entity's financial statements?

See **Answer** at the end of this chapter.

Professional skills focus: Concluding, recommending and communicating

While IAS 10 was covered at earlier levels, the focus at Advanced Level will be on more complex scenarios, where conclusions will need to be drawn.

2 IAS 37, Provisions, Contingent Liabilities and Contingent Assets

Section overview

The following is a summary of the material covered in earlier studies.

2.1 Overview of earlier studies

Definition

Provision: A liability where there is uncertainty over its timing or the amount at which it will be settled.

2.1.1 Recognition

- A provision should be recognised when:
  - an entity has a present obligation (legal or constructive) as a result of a past event;
  - it is probable that there will be an outflow of resources in the form of cash or other assets; and
  - a reliable estimate can be made of the amount.
- A provision should not be recognised in respect of future operating losses since there is no present obligation arising from a past event.

2.1.2 Onerous contracts

- If future benefits under a contract are expected to be less than the unavoidable costs under it, the contract is described as onerous. The excess unavoidable costs should be provided for at the time a contract becomes onerous.
- A lease agreement that becomes onerous is only within the scope of IAS 37, and therefore results in the creation of a provision, if simplified accounting is applied, so that no lease liability has been recognised. This is only the case where a lease is short-term or for an asset with a low value.

Definition

Unavoidable costs: Unavoidable costs of meeting an obligation are the lower of:

- the cost of fulfilling the contract; and
- any penalties from failure to fulfil the contract

2.1.3 2020 Amendment

In May 2020, the IASB issued an amendment to IAS 37, *Onerous Contracts – Cost of Fulfilling a Contract*. This clarifies that the cost of fulfilling the contract includes the costs that relate directly to the contract. These costs include the incremental costs of fulfilling the contract (eg, labour and materials) as well as an allocation of other direct costs (eg an allocation of depreciation of a machine used in fulfilling the contract) (IAS 37: para. 68A).

This amendment is effective for annual reporting periods beginning on or after January 1, 2022. It is therefore not yet examinable in full, but you should be aware of it as a current issue.

2.1.4 Restructuring costs

- A constructive obligation, requiring a provision, only arises in respect of restructuring costs where the following criteria are met:
  - A detailed formal plan has been made, identifying the areas of the business and number of employees affected with an estimate of likely costs and timescales
  - An announcement has been made to those who will be affected by the restructuring

2.1.5 Contingent liability

- A contingent liability arises where a past event may lead to an entity having a liability in the future but the financial impact of the event will only be confirmed by the outcome of some future event not wholly within the entity's control.
- A contingent liability should be disclosed in the financial statements unless the possible outflow of resources is thought to be remote.

2.1.6 Contingent asset

- A contingent asset is a potential asset that arises from past events but whose existence can only be confirmed by the outcome of future events not wholly within an entity's control.
- A contingent asset should be disclosed in the financial statements only when the expected inflow of economic benefits is probable.

2.1.7 Reimbursement

- An entity may be entitled to reimbursement from a third party for all or part of the expenditure required to settle a provision. In these circumstances, an entity generally retains the contractual obligation to settle the expenditure. A provision and reimbursement are therefore recognised separately in the statement of financial position. A reimbursement should be recognised only when it is virtually certain that an amount will be received.

2.1.8 Recognition and disclosure

- A full reconciliation of movements in provisions should be presented in the financial statements. Detailed narrative explanations should also be provided in relation to provisions, contingent liabilities and contingent assets. The narrative should include an estimate of the financial amount in relation to contingent liabilities and assets as well as indications of uncertainties.
- The required disclosures have already been covered at Professional Level. In particular, in relation to discounting, any increase in the value of the discounted amount arising from the passage of time or the effect of any change in the discount rate need to be disclosed.

2.1.9 Disclosure let out

- IAS 37 permits reporting entities to avoid disclosure requirements relating to provisions, contingent liabilities and contingent assets if they would be expected to be **seriously prejudicial** to the position of the entity in dispute with other parties. However, this should only be employed in **extremely rare** cases. Details of the general nature of the provision/contingency must still be provided, together with an explanation of why it has not been disclosed.

2.1.10 Discounting to present value

- Where the time value of money is material, the amount of provision should be the present value of the expenditures required to settle the obligation. The main types of provision where the impact of discounting may be significant are those relating to decommissioning and other environmental restoration liabilities. For most other provisions, no discounting will be required, as the cash flows are not sufficiently far into the future.

- The discount rate to be used should reflect current market assessments of the time value of money and the risks specific to the liability (ie, it would be a risk-adjusted rate). In practice it may be more appropriate to use a risk-free rate and adjust the cash flows for risk. For further guidance on the risk-free rate you may refer to your Strategic Business Management Workbook. Whichever method is adopted, it is important not to double count risk.

2.1.11 Unwinding the discount

- Where discounting is used, the carrying amount of the provision increases each period to reflect the passage of time and this is recognised as a finance cost in profit or loss.

Professional skills focus: Assimilating and using information

As the above overview from earlier studies shows, deciding whether a provision should be made and if so, how much, may require complex information to be assimilated. In particular, when considering the discount rate, the risks specific to the liability must be taken into account.

Interactive question 4: Constructive obligation

On 25 September 20X7, further to a decision made earlier in the year by the board of directors, Industrial plc publicly announced a decision to reduce the level of harmful emissions from its manufacturing plants.

The directors had reached their decision to proceed with the project after appraising the investment using discounted cash flow techniques and an annual discount rate of 8%.

The directors estimated that the future cash payments required to meet their stated objective would be as follows:

- £20 million on 30 September 20X8
- £25 million on 30 September 20X9
- £30 million on 30 September 20Y0

No contracts were entered into until after the start of the new accounting year on 1 October 20X7; however, the entity has a reputation of fulfilling its financial commitments after it has publicly announced them. Industrial included a provision for the expected costs of its proposal in its financial statements for the year ended 30 September 20X7. The actual expenditure in September 20X8 was
£20 million as expected.

The average remaining useful lives of the factories on 30 September 20X7 (the reporting date) was 30 years and depreciation is computed on a straight-line basis and charged to cost of sales.

Requirements

4.1 Compute the appropriate provision in the statements of financial position in respect of the proposed expenditure at 30 September 20X7 **and** 30 September 20X8, and explain why the directors decided to recognise the provision.

4.2 Compute the two components of the charge to profit in respect of the proposal for the year ended 30 September 20X8. You should explain how each component arises and identify where in the statement of profit or loss and other comprehensive income each component is reported.

See **Answer** at the end of this chapter.

Professional skills focus: Structuring problems and solutions

The interactive question you have just done is an example of structuring problems, both on your part and the part of the directors in the scenario. First, an investment appraisal is carried out by the directors, then the provision is announced, then calculated by you.

Interactive question 5: Unwinding the discount

A company has a present obligation at 31 December 20X0, which it expects to settle in four years' time for £200,000. It calculates that the present value of the obligation is £136,603, discounted at 10%.

The unwinding of the discount in 20X1, 20X2, 20X3 and 20X4 is shown in the table below.

Provision

	Cr balance b/f 1 Jan	Cr unwinding discount @ 10% 31 Dec	Cr balance c/f 31 Dec
	£	£	£
20X1	136,603	13,660	150,263
20X2	150,263	15,026	165,289
20X3	165,289	16,529	181,818
20X4	181,818	18,182	200,000

Requirement

What are the accounting entries for the above for 20X1?

See **Answer** at the end of this chapter.

Professional skills focus: Applying judgement

In the case of provisions, it is likely that the discount rate will be given to you. However, in other cases and in practice, choosing an appropriate discount rate is an area where judgement may need to be exercised. Selecting an appropriate discount rate is important as different discount rates can have a significant effect on the calculation.

Interactive question 6: Restructuring

How should these matters be recognised in the statement of profit or loss and other comprehensive income?

Requirements

6.1 An entity has a 31 December year end. The directors approved a major restructuring programme on 1 December 20X5 and announced the details on the entity's intranet and to the media on 2 December 20X5. The programme involves two stages.

Stage 1

Closure of three production lines during 20X6, the redundancy of 3,000 employees on 31 March 20X6, and the transfer during 20X6 of 500 employees to continuing parts of the business. All associated costs would be settled during 20X6.

Stage 2

Probable closure of four more production lines during 20X7, with probable redundancies of 3,500 employees during 20X7. Other staff will be transferred to continuing businesses. All associated costs would be settled during 20X7. Assume that the details of Stage 2 were formally confirmed on 1 November 20X6.

6.2 The entity had some years ago signed a 'take or pay' contract with a supplier, in order to ensure the reliable supply each year of 100,000 tonnes of critical raw materials to each of the seven production lines affected by the restructuring programme. Under the contract, the entity must pay for the 700,000 tonnes each year, even if it decides not to take delivery. This contract falls due for renewal on 1 January 20X8.

See **Answer** at the end of this chapter.

Interactive question 7: Obligation to dismantle

A company is awarded a contract to build and operate a nuclear power station on 1 January 20X1. The power station comes into operation on 31 December 20X3 and the operating licence is for 30 years from that date.

The construction cost of the power station was £450 million. Part of the agreement for the contract was that, in addition to building and operating the power station, the company is obliged to dismantle it at the end of its 30-year life and make the site safe for alternative use. At 31 December 20X3, the estimated cost of the obligation was £50 million.

An appropriate discount rate reflecting market assessments of the time value of money and risks specific to the power station is 8%.

Requirement

Explain the treatment of the cost of the power station and obligation to dismantle it as at 31 December 20X3 and for the year ended 31 December 20X4.

Work to the nearest £0.1 million.

See **Answer** at the end of this chapter.

3 Audit focus

Section overview

Auditors will carry out specific procedures on provisions and contingencies.

3.1 Auditing provisions and contingencies

Much of the audit work here is focused on ensuring that the recognition and treatment of these items is in accordance with IAS 37, which we looked at in section 2 of this chapter.

The audit procedures that should be carried out on provisions and contingent assets and liabilities are as follows.

- **Obtain details** of all **provisions** which have been included in the **accounts** and all **contingencies** that have been disclosed.
- **Obtain** a **detailed analysis** of all **provisions** showing opening balances, movements and closing balances.
- **Determine** for each material provision **whether** the **company** has a **present obligation** as a result of past events by:
  - **reviewing** of **correspondence** relating to the item; and
  - **discussing** with the **directors**. Have they created a valid expectation in other parties that they will discharge the obligation?
- **Determine** for each material provision **whether** it is **probable** that a **transfer of economic benefits** will be required to settle the obligation by:
  - **confirming** whether any **payments** have been **made** after the end of the reporting period in respect of the item;
  - **reviewing correspondences** with solicitors, banks, customers, insurance company and suppliers both pre and post year end for evidence of the existence of any liabilities;
  - **sending** a **letter** to the **solicitor** to obtain their views (where relevant);
  - **discussing** the **position** of similar **past provisions** with the directors. Were these provisions eventually settled?; and
  - **considering** the **likelihood** of **reimbursement**.
- **Recalculate** all **provisions** made.
- **Compare** the **amount provided** with any post year end payments and with any amount paid in the past for similar items.
- In the event that it is not possible to estimate the amount of the **provision**, confirm that this **contingent liability** is **disclosed** in the accounts.
- **Consider** the **nature** of the **client's business**. Would you expect to see any other provisions, for example warranties?
- **Consider** whether disclosures of **provisions, contingent liabilities and contingent assets** are correct and sufficient.

3.2 Procedures regarding litigation and claims

3.2.1 Introduction

- ISA 501, *Audit Evidence – Specific Considerations for Selected Items* provides guidance on procedures regarding litigation and claims.

A summary of the procedures regarding litigation and claims is provided below.

3.2.2 Litigation and claims

Litigation and claims involving the entity may have a material effect on the financial statements, and so will require adjustment to or disclosure in those financial statements.

The auditor shall **design and perform procedures** in order to identify any litigation and claims involving the entity which may give rise to a risk of material misstatement. (ISA 501.9)

Such procedures would include the following:

- Make appropriate **inquiries of management and those charged with governance** including obtaining **representations**.
- **Review board minutes** and **correspondence** with the entity's lawyers.

- Examine **legal expense account**.
- Use **any information** obtained regarding the entity's business including information obtained from discussions with any in-house legal department.

When litigation or claims have been identified or when the auditor believes they may exist, the auditor must seek **direct communication with the entity's lawyers**. (ISA 501.10)

This will help to obtain **sufficient, appropriate audit evidence** as to whether potential material litigation and claims are known and management's estimates of the financial implications, including costs, are reliable.

Form of the letter of inquiry

The letter, which should be prepared by management and sent by the auditor, should request the lawyer to **communicate directly** with the auditor.

If it is thought unlikely that the lawyer will respond to a general inquiry, the letter should specify the following.

- A list of litigation and claims
- Management's assessment of the outcome of the litigation or claim and its estimate of the financial implications, including costs involved
- A request that the lawyer confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the lawyer to be incomplete or incorrect

The auditors must consider these matters **up to the date of their report** and so a further, updating letter may be necessary.

A meeting between the auditors and the lawyer may be required, for example where a complex matter arises, or where there is a disagreement between management and the lawyer. Such meetings should take place only with the permission of management, and preferably with a management representative present.

If management refuses to give the auditor permission to communicate with the entity's lawyers or if the lawyer refuses to respond as required and the auditor can find no alternative sufficient evidence, this would mean that the auditor is unable to obtain sufficient, appropriate evidence and should ordinarily lead to a qualified opinion or a disclaimer of opinion. (ISA 501.11)

Interactive question 8: Contingencies

In February 20X7 the directors of Newthorpe Engineering suspended the managing director. At a disciplinary hearing held by the company on 17 March 20X7 the managing director was dismissed for gross misconduct, and it was decided the managing director's salary should stop from that date and no redundancy or compensation payments should be made.

The managing director has claimed unfair dismissal and is taking legal action against the company to obtain compensation for loss of his employment. The managing director says he has a service contract with the company which would entitle him to two years' salary at the date of dismissal.

The financial statements for the year ended 30 April 20X7 record the resignation of the director. However, they do not mention his dismissal and no provision for any damages has been included in the financial statements.

Requirements

8.1 State how contingent liabilities should be disclosed in financial statements according to IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

8.2 Describe the audit procedures you will carry out to determine whether the company will have to pay damages to the director for unfair dismissal, and the amount of damages and costs which should be included in the financial statements.

Note: Assume the amounts you are auditing are material.

See **Answer** at the end of this chapter.

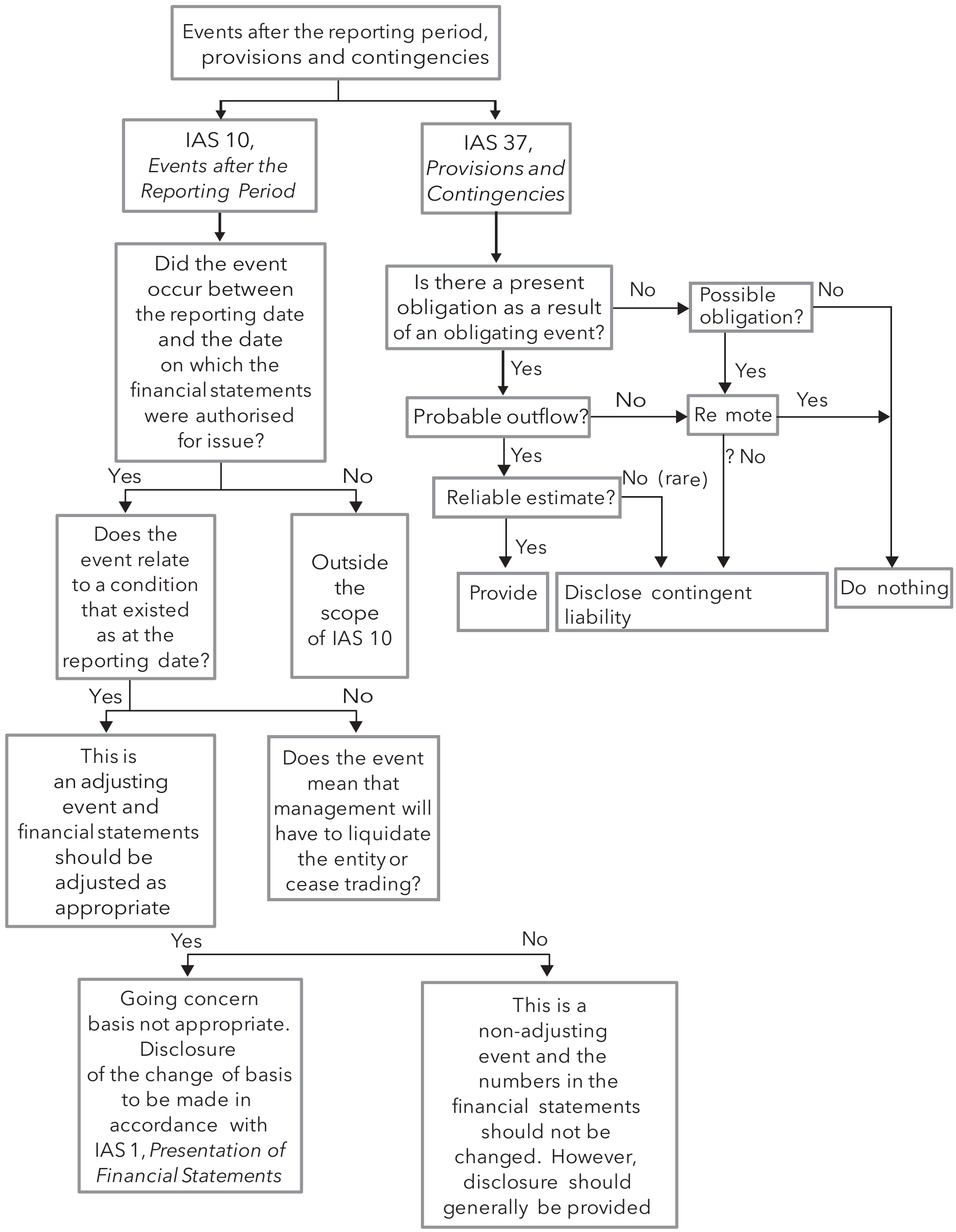
Professional skills focus: Applying judgement

Provisions are an area where judgement is required, for example in assessing the likelihood of success of a legal claim. In an exam, you are generally told whether a claim is likely to be successful, but in practice it could be difficult to determine.

3.3 Procedures regarding events after the reporting period

ISA 560, *Subsequent Events* sets out the audit requirements in relation to events occurring after the reporting period. Please refer to earlier chapters for a more detailed discussion.

Summary



Events after the reporting period, provisions and contingencies
IAS 10, *Events after the Reporting Period*
IAS 37, *Provisions and Contingencies*
Did the event occur between the reporting date and the date on which the financial statements were authorised for issue?
Yes
No
Does the event relate to a condition that existed as at the reporting date?
Outside the scope of IAS 10
Yes
No
This is an adjusting event and financial statements should be adjusted as appropriate
Does the event mean that management will have to liquidate the entity or cease trading?
Yes
No
Going concern basis not appropriate. Disclosure of the change of basis to be made in accordance with IAS 1, *Presentation of Financial Statements*
This is a non-adjusting event and the numbers in the financial statements should not be changed. However, disclosure should generally be provided
Is there a present obligation as a result of an obligating event?
No
Possible obligation?
No
Yes
Yes
Probable outflow?
No
Re mote
Yes
Yes
? No
Reliable estimate?
No (rare)
Yes
Provide
Disclose contingent liability
Do nothing

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	What is an adjusting event (IAS 10)? Give examples (Topic 1)
2.	What are IAS 10's requirements in relation to dividends? (Topic 1)
3.	When should a provision be recognised? (Topic 2)
4.	When, if at all, should a contingent liability be recognised? (Topic 2)
5.	When, if at all, should a contingent asset be recognised? (Topic 2)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Saimaa	This question revises knowledge of IAS 10, but requires application to an outcome that is uncertain.
Quokka	This question is good practice because it tests the interaction of two standards: IAS 10 and IAS 2.
Wilcox	In this question your brought forward knowledge of IAS 37, including discounting, is tested.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios to help you improve knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Upstart Records (Exhibit 3)	This tests IAS 37 in the context of a restructuring plan in considerably more depth and complexity than at earlier levels.
Newpenny (Exhibit 1 (1))	You will need to determine whether a provision is required for additional payment if a set volume of purchases is not met.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving onto the next chapter.

Technical reference

1 IAS 10, *Events After the Reporting Period*

- Authorisation
  - Process of authorisation of financial statements – **IAS 10.4**
  - Authorisation date is the date on which financial statements are authorised for issue to shareholders – **IAS 10.5, 10.6**
  - The relevant cut-off date for consideration of events after the reporting period is the authorisation date – **IAS 10.7**
- Adjusting events
  - Amounts recognised in financial statements should be adjusted to reflect adjusting events after the reporting date – **IAS 10.8, 10.9**
  - Examples of adjusting events include
    - Outcome of court case that confirms obligation at reporting date
    - Receipt of information on recoverability or value of assets
    - Finalisation of profit sharing or bonus payments
    - Discovery of fraud or errors
- Non-adjusting events
  - An entity should not adjust amounts recognised in financial statements for non-adjusting events after the reporting period (an example is the subsequent decline of market value of investments) – **IAS 10.10**
  - Non-adjusting events may need to be disclosed – **IAS 10.10**
  - Dividends proposed or declared on equity instruments after the reporting date cannot be recognised as a liability at the reporting date – **IAS 10.12**
  - Dividends proposed or declared after the reporting date should be disclosed – **IAS 10.13**
- Going concern basis
  - Financial statements are not to be prepared on going concern basis if management intends to liquidate entity or cease trading – **IAS 10.14**
  - If going concern assumption no longer appropriate, disclosures required in accordance with IAS 1 – **IAS 10.16**
- Disclosure
  - Date of authorisation to be disclosed – **IAS 10.17**
  - Disclosures relating to information after the reporting date to be updated in the light of new information – **IAS 10.19**
  - For material non-adjusting events after the reporting period an entity shall disclose: – **IAS 10.21**
    - Nature of event
    - Estimate of financial effect

2 IAS 37, Provisions, Contingent Liabilities and Contingent Assets

- Scope – **IAS 37.1**
- Definitions – **IAS 37.10**

- Recognition of provisions – **IAS 37.14–15**
- Contingent liabilities – **IAS 37.27**
- Contingent assets – **IAS 37.31**
- Measurement best estimate – **IAS 37.36**
- Risks and uncertainties – **IAS 37.42**
- Present value – **IAS 37.45-47**
- Future events – **IAS 37.48**
- Onerous contracts – **IAS 37.66**
- Restructuring – **IAS 37.70–72, IAS 37.78–80**

3 ISA 501

- Audit procedures in respect of litigation and claims – **ISA 501.9–12**

Self-test questions

Answer the following questions.

1 ABC International

ABC International Inc is a company that deals extensively with overseas entities and its financial statements include a substantial number of foreign currency transactions. The entity also holds a portfolio of investment properties.

Requirements

Discuss the treatment of the following events after the reporting date.

(a) Between the reporting date of 31 December 20X6 and the authorisation date of 20 March 20X7, there were significant fluctuations in foreign exchange rates that were outside those normally expected.

(b) The entity obtained independent valuations of its investment properties at the reporting date based on current prices for similar properties. On 15 March 20X7, market conditions which included an unexpected rise in interest rates and the expectation of further rises resulted in a fall in the market value of the investment properties.

(c) A competitor introduced an improved product on 1 February 20X7 that caused a significant price reduction in the entity's own products.

2 Saimaa

The Saimaa Company operates in the banking industry. It is attempting to sell one of its major administrative office buildings and relocate its employees.

Saimaa has found a potential buyer, The Nipigon Company, which operates a chain of retail stores. Nipigon would like to convert the building into a new retail store but would require planning permission for this change of use. Nipigon may, however, still consider purchasing the building and using it for its own administrative offices if planning permission is declined. It is estimated that there is approximately a 50% probability of planning permission being granted.

A contract for sale of the building is to be drawn up in November 20X7 and two alternatives are available:

Contract 1: This sale contract would be made conditional on planning permission being granted. Thus the contract would be void if planning permission is not granted but it would otherwise be binding.

Contract 2: This contract would be unconditional and binding, except that the price would vary according to whether or not planning permission is granted.

The financial statements of Saimaa for the year to 31 December 20X7 are authorised for issue on 28 March 20X8. A decision on planning permission will be made in February 20X8.

Requirement

With respect to the financial statements of Saimaa for the year to 31 December 20X7, and according to IAS 10, *Events After the Reporting Period*, indicate whether the granting of planning permission on each of the contracts is an adjusting event.

3 Quokka

The Quokka Company manufactures balers for agricultural use. The selling price per baler, net of selling expenses, at 31 December 20X7 is £38,000. Due to increasing competition, however, Quokka decides to reduce the selling price by £5,000 on 3 January 20X8.

On 4 January 20X8 a health and safety report was delivered to Quokka by the government, showing that some of its balers were toppling over on moderate gradients. £9,000 per baler would need to be incurred by Quokka to correct the fault. No further sales could be made without the correction.

Quokka had been unaware of any problem or health and safety investigation until the report was delivered.

The financial statements of Quokka for the year to 31 December 20X7 are to be authorised for issue on 23 March 20X8.

The cost of manufacture for each baler was £36,000 and there were 80 balers in inventory at 31 December 20X7.

Requirement

After adjustment (if any) for the above events, what should be the carrying amount of the inventory in the financial statements of Quokka at 31 December 20X7, in accordance with IAS 10, *Events After the Reporting Period* and IAS 2, *Inventories*?

4 Labeatis

The financial statements of the Labeatis Company for the year to 31 December 20X7 were approved and issued with the authority of the board of directors on 6 March 20X8. However, the financial statements were not presented to the shareholders' meeting until 27 March 20X8.

The following events took place:

Event 1: On 18 February 20X8 the Government announced a retrospective increase in the tax rate applicable to Labeatis's year ending 31 December 20X7.

Event 2: On 19 March 20X8 a fraud was discovered which had had a material effect on the financial statements of Labeatis for the year ending 31 December 20X7.

Requirement

State which event (if any) is an adjusting event according to IAS 10, *Events After the Reporting Period*.

5 Scioto

The Scioto Company's financial statements for the year ended 30 April 20X7 were approved by its finance director on 7 July 20X7 and a public announcement of its profits for the year was made on 10 July 20X7.

The board of directors authorised the financial statements for issue on 15 July 20X7 and they were approved by the shareholders on 20 July 20X7.

Requirement

Under IAS 10, *Events After the Reporting Period*, after which date should consideration no longer be given as to whether the financial statements to 30 April 20X7 need to reflect adjusting and non- adjusting events?

6 Fushia

The Fushia Company sells electrical goods covered by a one-year warranty for any defects.

Of sales of £60 million for the year, the company estimates that 3% will have major defects, 6% will have minor defects and 91% will have no defects.

The cost of repairs would be £5 million if all the products sold had major defects and £3 million if all had minor defects.

Requirement

What amount should Fushia provide as a warranty provision?

7 Wilcox

The Wilcox Company has been lead mining in Valovia for many years. To clean the lead, Wilcox uses toxic chemicals which are then deposited back into the mines. Historically there has not been any legislation requiring environmental damage to be cleaned up. The company has a policy of only observing its environmental responsibilities when legally obliged.

In December 20X7, the Government of Valovia introduced legislation on a retrospective basis, forcing mining companies to rectify environmental damage that they have caused.

Wilcox estimates that the damage already caused will cost £27 million to rectify, but the work would not be paid for until December 20X9. It also estimates that damage caused by its operations each year for the remaining four years of the mines' lifespan will be £3 million, payable at the end of the relevant year.

17% is the pre-tax rate that reflects the time value of money and the risk specific to these liabilities.

Requirement

To the nearest £1 million, what provision should be shown in the statement of financial position of Wilcox at 31 December 20X7 under IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*?

8 Noble

The Noble Company operates a fleet of commercial aircraft. On 1 April 20X7, a new law was introduced requiring all operators to use aircraft fitted with fuel-efficient engines only.

At 31 December 20X7 Noble had not fitted any fuel-efficient engines and the total cost of fitting them throughout the fleet was estimated at £4.2 million.

Under the terms of the legislation, the company is liable for a fine of £1 million for non-compliance with legislation for any calendar year, or part of a year, in which the law has been broken. The Government rigorously prosecutes all violations of the new law.

The effect of the time value of money is immaterial.

Requirement

State the provision required in Noble's financial statements for the year ended 31 December 20X7 under IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

The £35,000 profit share payment and the £31,000 bad debt expense are adjusting events and should be recognised in the financial statements.

See IAS 10.9, 10.12 and 10.22.

Answer to Interactive question 2

(a) This is an adjusting event, as it provides more up to date information about a provision that was recognised at the reporting date. The £100,000 receivable should be written off.

(b) This is a disclosable non-adjusting event. The rights issue occurred after the reporting date, but is considered to be of significant importance and should be disclosed in the financial statements.

(c) This is an adjusting event since it is in relation to an asset that was recognised at the reporting date. The receivable should be reduced to £500,000.

Answer to Interactive question 3

These dividends will be dealt with in the entity's financial statements for 20X2, 20X3 and 20X4 as follows:

Financial statements for:	20X2	20X3	20X4
20X2 final dividend	Disclosed in the notes	Charged to statement of changes in equity	–
20X3 interim dividend	–	Charged to statement of changes in equity	–
20X3 final dividend	–	Disclosed in the notes	Charged to statement of changes in equity

Answer to Interactive question 4

4.1 Provision at 30 September 20X7

Expenditure on:		**£'000**
30 September 20X8	20,000 × 0.926	18,520
30 September 20X9	25,000 × 0.857	21,425
30 September 20Y0	30,000 × 0.794	23,820
		63,765

Provision at 30 September 20X8

Expenditure on:		**£'000**
30 September 20X9	25,000 × 0.926	23,150
30 September 20Y0	30,000 ×0.857	25,710
		48,860

A provision should be recognised where:

(1) there is a present obligation as a result of a past event;

(2) there is a probable outflow of economic benefits; and

(3) the amount can be measured reliably.

(2) and (3) are clearly met, as Industrial will incur expenditure and the detailed estimates of the amounts have been prepared.

By announcing the plan to reduce emissions publicly, Industrial has created a constructive obligation to carry out the project. Therefore, although there is no legal obligation, Industrial should record a provision for the estimated (and discounted) costs of the project.

4.2 The charge to profit or loss for the year ended 30 September 20X8 consists of:

(1) Depreciation (£63,765,000 ÷ 30) = £2,125,500 This is reported in cost of sales.

The provision of £63,765,000 also represents an **asset**, as it gives rise to future economic benefits (it enhances the performance of the factories). This is **capitalised and depreciated over 30 years** (the average useful life of the factories).

(2) Unwinding of the discount (see working) = £5,095,000 This is reported as a **finance cost**.

WORKING

	£'000
Provision at 1 October 20X7	63,765
Expenditure on 30 September 20X8	(20,000)
Unwinding of discount (balancing figure)	5,095
Provision at 30 September 20X8	48,860

Answer to Interactive question 5

The accounting entry to record the unwinding of the discount in 20X1 will be:

DEBIT	Finance costs	£13,660	
CREDIT	Provisions		£13,660

Answer to Interactive question 6

6.1 Detailed information was made available about who would be affected by Stage 1 and when the various steps in the first stage of the closure programme would take place.

The announcement about Stage 2 was more of an overview. It was not until 1 November 20X6 that information was announced in respect of Stage 2 in as much detail as that provided in December 20X5 about Stage 1. There is a constructive obligation in respect of Stage 1 on 2 December 20X5; no such obligation in respect of Stage 2 is made until 1 November 20X6.

Although the announcement is made as a single restructuring programme, there will be two entirely separate restructuring provisions.

The costs of this major programme will be recognised in profit or loss for the years ending 31 December 20X5–20X7 as follows:

	Reason	Stage 1	Stage 2
Termination payments to those taking voluntary redundancy	Restructuring provision	20X5	20X6
Termination payments to those being made compulsorily redundant	Restructuring provision	20X5	20X6
Employment costs during closing down activities and selling off inventory	Restructuring provision	20X5	20X6
One-off payments to employees agreeing to move to continuing parts of the business	Continuing activities	20X6	20X7
Cost of moving plant and equipment to continuing parts of the business	Continuing activities	20X6	20X7
Cost of moving saleable inventory to continuing parts of the business	Continuing activities	20X6	20X7
Impairment losses on non-current assets	See Note	20X5 & 20X6	20X5 to 20X7
Losses on disposal of non-current assets	Year when loss on disposal incurred	20X6	20X7
Revenue less expenses up to date of closure, other than itemised expenses	Year when operating losses incurred	20X6	20X7

Note: The announcement of a restructuring programme is an indicator of impairment under IAS 36, so an impairment test should be carried out at the time of the first announcement for all relevant non-current assets. Despite Stage 2 only being 'probable', its assets should still be tested for impairment in 20X5.

6.2 A provision should be recognised in respect of all contracts when they become onerous, regardless of whether this is associated with a restructuring programme. If the entity's production lines were loss-making before the restructuring announcement, then this contract may already have been classified as onerous.

If it had not already been identified as being onerous then, at a minimum, a provision should be made for the 300,000 tonnes per annum for the three Stage 1 production lines, for the period from when they cannot take any further supplies through to the end of the contract on 31 December 20X7.

A provision should be made for the remaining 400,000 tonnes per annum for the four Stage 2 production lines for the period from when they cannot take any further supplies through to the end of the contract on 31 December 20X7.

Note: This answer includes a comprehensive list of issues to be considered under restructuring programmes, included for learning purposes.

Answer to Interactive question 7

At 31 December 20X3

The discounted amount of the provision would be included in the initial measurement of the cost of the power station as at 31 December 20X3:

	£m
Cost	450.0
Provision (£50m × $1/1.08^{30}$)	5.0
	455.0

Year ended 31 December 20X4

The power plant would be depreciated over its 30-year life resulting in a charge of £455.0m/30 = £15.2m to profit or loss and a carrying amount of £455m – £15.2m = £439.8m.

The provision would begin to be compounded resulting in an interest charge of £5.0 × 8% = £0.4m and an outstanding provision of £5.0 + £0.4 = £5.4m in the statement of financial position.

Any change in the expected present value of the provision would be made as an adjustment to the provision and to the asset value (affecting future depreciation charges).

Answer to Interactive question 8

8.1 IAS 37 states that a provision should be recognised in the accounts if:

- an entity has a **present obligation** (legal or constructive) as a result of a past event;
- a **transfer** of **economic benefits** will **probably** be **required** to settle the obligation; and
- a **reliable estimate** can be **made** of the amount of the obligation.

Under IAS 37 contingent liabilities should not be recognised. However, they should be disclosed unless the prospect of settlement is remote. The entity should disclose:

- the **nature** of the liability;
- an estimate of its **financial effect**;
- the **uncertainties** relating to any possible payments; and
- the likelihood of any **reimbursement**.

8.2 The following procedures should be carried out to determine whether the company will have to pay damages and the amount to be included in the financial statements.

- **Review** the director's **service contract** and **ascertain** the **maximum amount** to which he would be entitled and the **provisions** in the service contract that would **prevent** him making a **claim**, in particular those relating to grounds for justifiable dismissal.
- **Review** the results of the **disciplinary hearing. Consider** whether the company has acted in accordance with **employment legislation** and its **internal rules**, the **evidence** presented by the **company** and the defence made by the **director**.
- **Review correspondence** relating to the case and **determine** whether the **company** has **acknowledged** any **liability** to the director that would mean that an amount for compensation should be accrued in accordance with IAS 37.
- **Review correspondence** with the company's **solicitors** and **obtain legal advice**, either from the company's solicitors or another firm, about the likelihood of the claim succeeding.
- **Review** correspondence and contact the company's solicitors about the likely **costs** of the case.
- **Consider** the **likelihood** of **costs** and **compensation** being **reimbursed** by **reviewing** the company's **insurance arrangements** and contacting the insurance company.

- **Consider** the **amounts** that should be **accrued** and the **disclosures** that should be made in the accounts. Legal costs should be accrued, but compensation payments should only be accrued if the company has admitted liability or legal advice indicates that the company's chances of success are very poor. However, the claim should be disclosed unless legal advice indicates that the director's chance of success appears to be remote.

Answers to Self-test questions

1 ABC International

(a) Details of the abnormal fluctuations in exchange rates should be disclosed as a non-adjusting event after the reporting period.

(b) The decline in the value of investment properties is a non-adjusting event, as it does not reflect the state of the market at the reporting date. The valuation should reflect the state of the market at the reporting date and should not be affected by hindsight or events at a later date.

(c) The improved product issued by the competitor is likely to have been developed over a period of time. The value of inventories should be reviewed and adjusted to their net realisable value where appropriate. Non-current assets may need to be reviewed for possible impairment. This is an adjusting event, as it reflects increased competitive conditions which existed at the reporting date even if the entity was not fully aware of them.

2 Saimaa

Contract 1 is a non-adjusting event. Contract 2 is an adjusting event.

Under IAS 10.3, events after the reporting period are those which occur after the reporting period but before the financial statements are authorised for issue. The planning permission decision is such an event, because it is to be made before the financial statements are to be authorised for issue on 28 March 20X8. Adjusting events are those providing evidence of conditions that existed at the reporting date and non-adjusting events are those indicative of conditions that arose after that date.

Under Contract 1, the uncertainty surrounding the contract at the reporting date would be such that no sale could be recognised as at that date. So there is no transaction for which the planning permission decision could provide evidence and there would not be an adjusting event.

Under Contract 2, there would be an unconditional sale recognised at the reporting date, with only the consideration needing to be confirmed after the reporting date. According to IAS 10.9(c) the planning permission decision would provide additional evidence of the proceeds and would be an adjusting event.

3 Quokka

£1,920,000

IAS 2.9 states that inventories should be stated at the lower of cost and NRV, and under IAS 10.9(b)(ii) the sale of inventories after the reporting date may give evidence of NRV at the reporting date.

The 3 January price reduction is a response to competitive conditions which would have existed at the reporting date. So even though it comes after the year end, it is an adjusting event. Similarly, the safety report received after the year end relates to conditions at the year end (as the balers in inventories were defective at this date) and is an adjusting event.

The carrying amount is 80 balers at the lower of cost (£36,000) and NRV £(38,000 – 5,000 – 9,000). So 80 × £24,000 = £1,920,000

4 Labeatis

Event 1 is a non-adjusting event. Event 2 happened after the statements were authorised, so does not constitute an event after the reporting period.

Applying IAS 10.3, events after the reporting period are those which occur after the 31 December 20X7 reporting date but before the financial statements are authorised for issue on 6 March 20X8.

Event 1 occurs before 6 March 20X8 but is a non-adjusting event, because in accordance with IAS 10.22(h) this change was not enacted before the reporting date. This is the case even though the announcement has a retrospective effect on the financial statements still being prepared.

Event 2, the discovery of fraud, would have been an adjusting event per IAS 10.9(e), had it occurred before the date of authorisation for issue. As it was not discovered until 19 March 20X8, it is not even an event after the reporting period, let alone an adjusting event.

5 Scioto

15 July is the correct answer.

IAS 10.7 states that the authorisation date is the date on which the financial statements are authorised for issue, even if this is after a public announcement of profit. IAS 10.5 confirms that it is not the date on which the shareholders approve the financial statements.

6 Fushia

£330,000

Provision must be made for estimated future claims by customers for goods already sold. The expected value (£5m × 3%) + (£3m × 6%) is the best estimate of this amount (IAS 37.39).

7 Wilcox

£20 million

At the year end a legal obligation exists – through the retrospective legislation – as a result of a past event (the environmental damage caused in the past) (IAS 37.14). The company should therefore create a provision for the damage that has already been caused.

It should not now set up a provision for the future damage, because that will be caused by a future event (the company could close down the mines and therefore not cause further damage to the environment).

Because the effect of discounting at 17% over two years is material, the cost should be discounted to present value (IAS 37.45).

So, the provision is $£27m/1.17^2$ = £20 million (to the nearest £m)

8 Noble

No provision is required for the fitting of the engines. This is because the present obligation as a result of the past event required by IAS 37.14 does not exist. The company can choose not to fit the engines and then not to operate the aircraft.

However, a provision of £1.0 million is required in relation to the fines, because at the reporting date there is a present obligation in respect of a past event (the non-compliance with legislation).

Chapter 14

Leases, government grants and borrowing costs

Introduction

Learning outcomes

- Determine and calculate how different bases for recognising, measuring and classifying financial assets and financial liabilities can impact upon reported performance and position
- Appraise and evaluate cash flow measures and disclosures in single entities and groups
- Explain and appraise accounting standards that relate to an entity's financing activities which include: financial instruments; leasing; cash flows; borrowing costs; and government grants
- Justify and conclude for a particular scenario what comprises sufficient, appropriate audit evidence
- Design and determine audit procedures in a range of circumstances and scenarios, for example identifying an appropriate mix of tests of controls, analytical procedures and tests of details
- Demonstrate and explain, in the application of audit procedures, how relevant ISAs affect audit risk and the evaluation of audit evidence

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
1	**Identifying a lease** Lease finance is a common route to acquiring assets. It is also topical, being the subject of a recent standard, IFRS 16, *Leases*. In a working context you may have to decide whether an arrangement constitutes a lease.	**Approach** Make sure you know the detailed definition of a lease by heart and are able to apply it to any scenario. **Stop and think** Do leases always need to be recognised in the statement of financial position?	'Is it a lease?' is a question that could well be asked in an exam, perhaps in the context of ethics, where a director wants to reduce gearing by claiming it isn't. Right of use is a key test in this respect.	**IQ2: Is it a lease?** This is an essential interactive question, covering a wide range of transactions that may or may not be leases.
2	**Lessee accounting** For lessees, all leases other than short leases and leases of low value assets must be	**Approach** As this is a recent, topical standard and ripe for examination, it is necessary to go	Once it is established that it is a lease, any aspect of IFRS 16 could be tested. A regular way of	**IQ3: Payments in arrears** This is a relatively straightforward question and should be done in

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
	recognised in the statement of financial position. 'Creative' accountants may try to argue that an arrangement is not a lease in order to avoid showing it in the SOFP and thereby reducing gearing.	through all worked examples and interactive questions very carefully. **Stop and think** How is the right-of-use asset made up?	testing this is a scenario in which the lease has been incorrectly treated, for example by just showing the lease payments as an expense in the SPL, rather than an asset in the SOFP. You would need to explain why this is wrong, calculate the correct figures and often adjust the financial statements for this and other errors.	conjunction with the rather trickier next question. **IQ4: Payments in advance** Doing these questions together will show clearly how the treatment differs.
3	**Sale and leaseback transactions** Sale and leaseback arrangements can provide entities with capital funding by releasing capital caught up in the business for investment in other core opportunities. You will later encounter sale and leaseback transactions again in practical real life situations in later Chapters on financial analysis.	**Approach** Ensure you understand the different scenarios relating to sale and leaseback. And the formula to calculate the right-of-use asset and the gain on the sale. **Stop and think** Why is it important to consider whether an arrangement constitutes a lease?	Sale and leaseback is a regular topic for examination. IFRS 16 interacts with IFRS 15 as the sale has to meet the IFRS 15 criteria for a sale in order to be treated as a genuine sale and leaseback.	**IQ6: Sale and leaseback where the transfer is a sale** This is a comprehensive question on this topic and will prepare you for most exam scenarios.
4	**Lessor accounting** It is common for a company to rent out a building, as you saw earlier in your studies of IAS 40, *Investment Property*.	**Approach** The key point to note is that for lessors, a distinction is made between finance leases, which transfer the risks and rewards of ownership, and operating leases, which do not. Finance leases are	Lessor accounting is less commonly examined than lessee accounting, but it does come up occasionally. It is very important in an exam that you consider carefully whether the company is a lessee or a lessor, as the	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
		recognised in the SOFP; operating lease receipts are credited to P/L **Stop and think** Why is the unguaranteed residual value of a leased asset important?	financial reporting treatment is very different in each case.	
5	**IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*** This is revision from your earlier studies.	**Approach** Revise IAS 20 through interactive questions and earlier material if necessary. **Stop and think** It is important to distinguish grants related to assets from grants related to income.	IAS 20 has not been tested under the current syllabus	**IQ8: Government grants** This is a quick revision question asking for an explanation of the two methods of recognising government grants.
6	**IAS 23, *Borrowing Costs*** This is revision from your earlier studies.	**Approach** Revise IAS 23 through interactive questions and earlier material if necessary. **Stop and think** Borrowing costs must be capitalised as part of the cost of the asset if they are directly attributable to acquisition/ construction/ production. Other borrowing costs must be expensed.	Borrowing costs are likely to be tested as part of a scenario also testing other PPE standards.	**IQ10: Borrowing costs 2** A detailed question covering any complications you are likely to encounter.
7	**Statements of cash flows** This section is for revision of single company statements of cash flows. You will cover	**Approach** Start off with the interactive question, referring to the summary only if you get stuck.	The statement of cash flows in an exam could be a consolidated one. The most likely context is a financial analysis question or	**IQ11: Single company statement of cash flows** You should be able to get this question almost completely right. If not, have a

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
	consolidated statements of cash flows in later Chapters.	**Stop and think** What are the benefits of a statement of cash flows?	analytical procedures question.	go at Self-test question 9 and practise questions from your earlier studies.
8	**Audit focus** This section is concerned with the audit of leases, following the structure of the financial reporting sections.	**Approach** Read and learn the table in Section 8.1, which takes you through the audit of lessees.	Exam questions could focus on the financial reporting of leases. Alternatively there could be an audit issue relating to leases which gives rise to a financial	N/A
		Stop and think With lessors, the main concern for the auditor will be establishing whether the arrangement is an operating lease or a finance lease.	reporting issue. In addition, an ethical issue may arise whereby a company claims that a transaction is not a lease, or, where the company is a lessor, that the lease is an operating lease rather than a finance lease.	

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Identifying a lease

Section overview

- A contract to obtain the use of an asset is within the scope of IFRS 16 if it meets the definition of a lease contract.
- IFRS 16 provides optional exemptions from the application of the standard lessee accounting model for short-term leases and leases of low-value assets.
- A contract may contain both a lease component and a non-lease component. IFRS 16 requires entities to account for the lease component of the contract separately from the non-lease component.

Tutorial note

You have studied leasing at Professional Level. If you feel confident in your knowledge, you may wish to skim-read the explanations and go straight to the examples and questions, coming back to the detail if you get stuck.

1.1 Leasing agreements and IFRS 16

As you learned in your Professional level studies, one way by which businesses can obtain the use of an asset is by a leasing agreement. A contract has to meet the definition of a lease contract to be in the scope of IFRS 16, *Leases*.

IFRS 16 was published in 2016. IFRS 16 takes the approach of a lessee measuring the 'right of use' of an asset, and recognising it on the statement of financial position.

Definitions

Lease: A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time, in exchange for consideration.

Underlying asset: An asset that is the subject of a lease, for which the right to use that asset has been provided by a lessor to a lessee.

In a leasing transaction, there is a contract between the lessor and the lessee for the hire of an asset.

- The **lessor** is owner and supplier of the underlying asset.
- The **lessee** is the entity who has the right to use the underlying asset.

The lessor retains legal ownership but transfers to the lessee the right to use the asset for an agreed period of time in return for specified payments.

Definition

Right-of-use asset: An asset that represents a lessee's right to use an underlying asset for the lease term.

Professional skills focus: Structuring problems and solutions

The below guidance provides a structure for identifying whether an arrangement is a lease. You should expect that at Advanced Level the issue may not be clear cut, so the guidance will provide a useful tool in making the decision.

1.2 Identifying a lease

Under IFRS 16, a contract is deemed to contain a lease if it conveys the right to control the use of an **identified asset** for a **period of time**, in return for consideration (usually cash, although this purposely doesn't restrict the definition).

The right to control the use of the underlying asset depends on the lessee having both:

- the right to obtain substantially all of the **economic benefits** from using the asset; and
- the **right to direct the use** of the identified asset.

Note: If the supplier can substitute the asset for an equivalent during the lease, the lessee is not deemed to have the right to use an identified asset.

Identified asset

- The asset must be specified in the lease.
- May be part of an asset (such as part of an office facility).
- If the supplier has the practical ability to substitute the asset for an equivalent during the lease, and would benefit economically from doing so (ie, they have a substantive substitution right), there is no identified asset and the contract is not a lease.

Period of time is either:

- a period of time, such as years; or
- the amount of use, based upon the production of the asset, such as number of units produced.

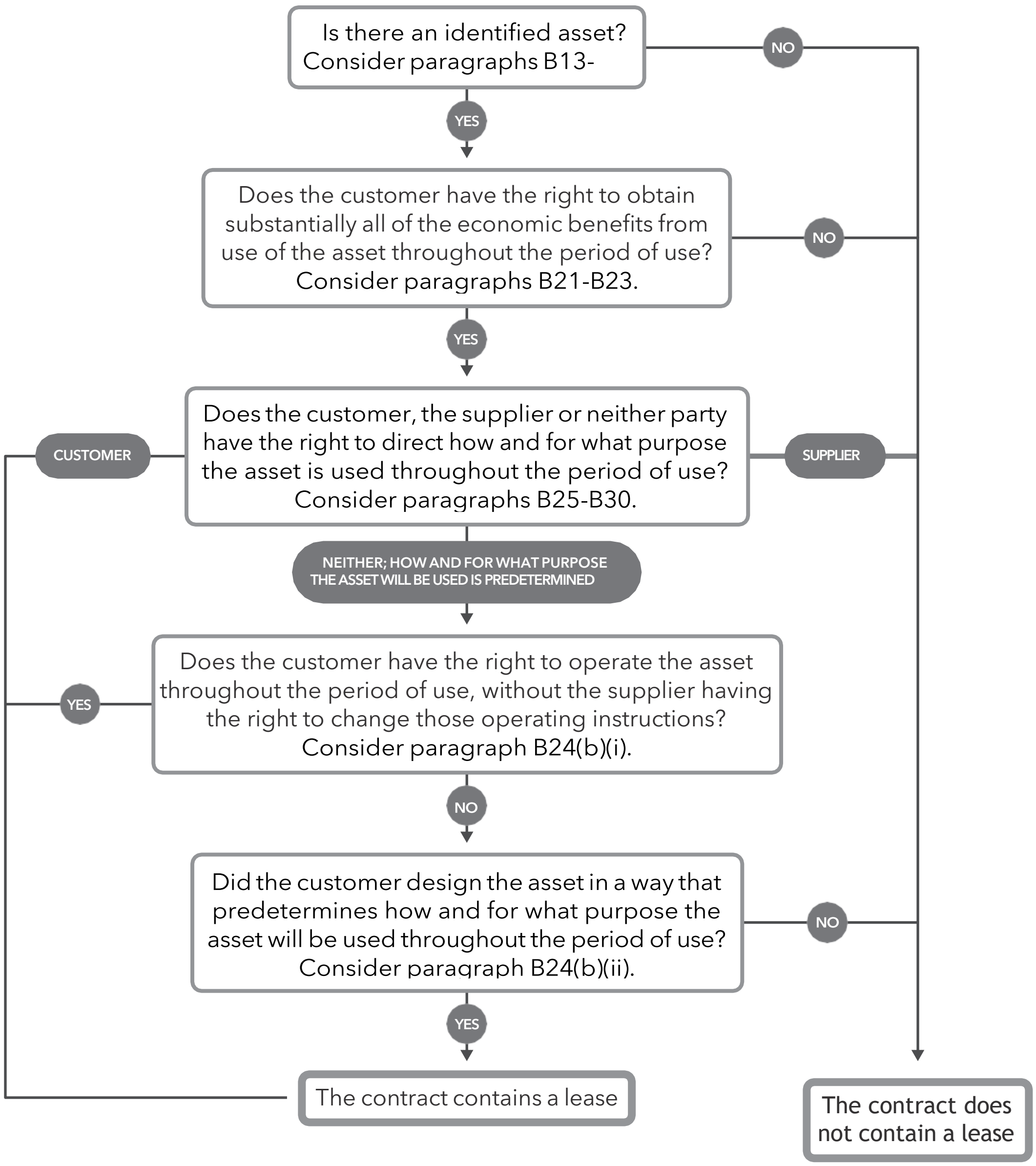
Right to obtain substantially all of the economic benefits

- Can be achieved through holding, using or sub-leasing the asset.
- Assessed only within the parameters of the contract eg, a lease contract for a car may restrict its use to within one country, in which case only economic benefits within that country are considered.

Right to direct the use of the asset (control)

- Lessee can direct how and for what purpose the asset is used throughout the period of use.
- Assessment is unaffected by protective rights within the terms of the contract that are designed to protect the asset eg, prohibiting a truck from being used to carry explosives.

The following flowchart, taken from IFRS 16, Appendix B, paragraph B31, may assist you in determining whether a lease should be identified in the examples that follow:



Worked example: Is it a lease 1?

Big Farm Ltd has three Fassey Mergason tractors under contract from Agrirental Ltd. The tractors are leased for five years, during which time Big Farm Ltd uses and keeps them on the farm, and they cannot be retrieved by Agrirental Ltd (except in the case of default of payment). Agrirental Ltd will supply a replacement tractor if any of the three requires servicing or repair. The tractors are returned to Agrirental Ltd after five years.

Requirement

Is this a lease?

Solution

This is a lease. There are **identifiable assets** (the three tractors), and Big Farm Ltd has the **right to direct their use** for the period of the contract in order to obtain **substantially all economic benefits** from them. Agrirental Ltd cannot substitute or swap one of the tractors, unless it requires a repair or servicing; this is not a substantive substitution right. Therefore, the contract is classified as a lease.

Worked example: Is it a lease 2?

Big Farm Ltd also has the use of two combine harvesters under contract from Agrirental Ltd. The contract agrees that Big Farm Ltd will have access to combine harvesters which have VARIO cutters, however, Agrirental Ltd can decide on the brand and specific machine supplied to Big Farm Ltd, albeit with VARIO cutters. As harvesting is not a year round activity, Agrirental Ltd retains the combine harvesters at its depot, but will supply them as requested within 24 hours.

Requirement

Is this a lease?

Solution

This is not a lease. There are **no identifiable assets** (the combine harvesters), and although Big Farm Ltd has the **right to use** the machines for the period of the contract, Agrirental Ltd can decide upon the actual combines (provided they have the VARIO cutters) provided to Big Farm Ltd.

Therefore the contract is not classified as a lease, and the rental payments should be expensed to profit or loss.

Professional skills focus: Assimilating and using information

In the above examples, the background is the same and some of the details are similar. Your task is to take account of all the information and focus on the differences.

Worked example: Is it a lease 3?

Outandabout Co provides tours round places of interest in the tourist city of Sightsee. While these tours are mainly within the city, it does the occasional day trip to visit tourist sites further away.

Outandabout Co has entered into a three-year contract with Fastcoach Co for the use of one of its coaches for this purpose. The coach must seat 50 people, but Fastcoach Co can use any of its 50- seater coaches when required.

Requirement

Is this arrangement a lease within the scope of IFRS 16, *Leases*?

Solution

This is not a lease. There is no identifiable asset. Fastcoach can substitute one coach for another, and would derive economic benefits from doing so in terms of convenience. Therefore Outandabout should account for the rental payments as an expense in profit or loss.

Worked example: Is it a lease 4?

Coketown Council has entered into a five-year contract with Carefleet Co, under which Carefleet Co supplies the council with 10 vehicles for the purposes of community transport. Carefleet Co owns the relevant vehicles, all 10 of which are specified in the contract. Coketown Council determines the routes taken for community transport and the charges and eligibility for discounts. The council can choose to use the vehicles for purposes other than community transport. When the vehicles are not being used, they are kept at the council's offices and cannot be retrieved by Carefleet unless Coketown Council defaults on payment. If a vehicle needs to be serviced or repaired, Carefleet is obliged to provide a temporary replacement vehicle of the same type.

Requirement

Is this a lease?

Solution

This is a lease. There is an identifiable asset, the 10 vehicles specified in the contract. The council has a right to use the vehicles for the period of the contract. Carefleet Co does not have the right to substitute any of the vehicles unless they are being serviced or repaired. Therefore Coketown Council would need to recognise an asset and liability in its statement of financial position.

Worked example: Is it a lease 5?

This example is taken from IFRS 16 illustrative example 3.

Kabal enters into a 10-year contract with a utilities company (Telenew) for the right to use three specified, physically distinct dark fibres within a larger cable connecting North Town to South Town. Kabal makes the decisions about the use of the fibres by connecting each end of the fibres to its electronic equipment (ie, Kabal 'lights' the fibres and decides what data, and how much data, those fibres will transport). If the fibres are damaged, Telenew is responsible for the repairs and maintenance. Telenew owns extra fibres, but can substitute those for Kabal's fibres only for reasons of repairs, maintenance or malfunction (and is obliged to substitute the fibres in these cases).

Requirement

Is this a lease?

Solution

This is a lease. The contract contains a lease of dark fibres. Kabal has the right to use the three dark fibres for 10 years.

There are three identified fibres. The fibres are explicitly specified in the contract and are physically distinct from other fibres within the cable. Telenew cannot substitute the fibres other than for reasons of repairs, maintenance or malfunction (IFRS 16: Para B18).

Kabal has the right to control the use of the fibres throughout the 10-year period of use because:

(1) Kabal has the right to obtain substantially all of the economic benefits from use of the fibres over the 10-year period of use and Kabal has exclusive use of the fibres throughout the period of use.

(2) Kabal has the right to direct the use of the fibres because IFRS 16: Para B24 applies:

   (a) The customer has the right to direct how and for what purpose the asset is used during the whole of its period of use, or

(b) The relevant decisions about use are pre-determined and the customer can operate the asset without the supplier having the right to change those operating instructions.

Kabal makes the relevant decisions about how and for what purpose the fibres are used by deciding

(a) when and whether to light the fibres and (b) when and how much output the fibres will produce (ie, what data, and how much data, those fibres will transport). Kabal has the right to change these decisions during the 10-year period of use.

Although Telenew's decisions about repairing and maintaining the fibres are essential to their efficient use, those decisions do not give Telenew the right to direct how and for what purpose the fibres are used. Consequently, Telenew does not control the use of the fibres during the period of use.

Professional skills focus: Concluding, recommending and communicating

The above example, taken from IFRS 16, analyses a complex situation and comes to a conclusion. In an exam, if you missed one of the details and came to a different conclusion, you would still gain credit for parts of your analysis that were correct.

1.3 Your exam

IFRS 16 was introduced because lease liabilities had been kept off the statement of financial position. There is still an incentive to do this, and preparers of financial statements who wish to do this may argue that a transaction is not a lease when in fact it is, and therefore should appear on the SOFP. An exam question could present an ethical dilemma, where the auditor or junior accounting staff member is under pressure to accept this incorrect financial reporting treatment.

1.4 Recognition exemptions

IFRS 16 provides optional exemptions from the application of the standard lessee accounting model. Instead of applying the recognition requirements of IFRS 16 described below, a lessee may **elect to** account for lease payments as an expense on a straight-line basis over the lease term or another systematic basis for the following two types of leases (IFRS 16: paras. 5, 6 and 8). These are available for:

- **Short term leases,** which are those for less than 12 months that do not contain a purchase option. The election to use the exemption must be made by asset class.
- **Leases for low value assets,** being assets with a low value when new (such as laptop computers, mobile phones or small items of office furniture). An asset can only be of low value if:
  - The lessee can benefit from using the underlying asset on its own or with other available resources; and
  - The underlying asset is not highly dependent on or interrelated with other assets, for example, a circuit board costing £200 but which is required to operate an item of plant worth £40,000.

This election may be made on a lease-by-lease basis.

Leases of low-value assets are leases of assets with a value, when new, of $5,000 or less (IFRS 16, Basis for Conclusions, para. 100).

Interactive question 1: Short lease

Oscar Co is preparing its financial statements for the year ended 30 June 20X6. On 1 May 20X6, Oscar made a payment of £32,000 for an eight-month lease of a milling machine.

Requirement

How should the transaction be recognised in the financial statements? See **Answer** at the end of this chapter.

Context example: Leases of low-value assets and portfolio application

IFRS 16 Illustrative Example 11 is of a lessee in the pharmaceutical manufacturing and distribution industry with leases including the following:

(a) Leases of IT equipment for use by individual employees (such as laptop computers, desktop computers, hand held computer devices, desktop printers and mobile phones)

(b) Leases of servers, including many individual modules that increase the storage capacity of those servers. The modules have been added to the mainframe servers over time as the lessee has needed to increase the storage capacity of the servers

(c) Leases of office equipment:

(1) Office furniture such as desks, chairs and partitions

(2) Water dispensers

The company determines that the leases of IT equipment to individual employees and the office furniture and water dispensers qualify as leases of low-value assets on the basis that the underlying assets, when new, are individually of low value.

However, although each module within the servers, if considered individually, might be an asset of low value, the leases of modules within the servers do not qualify as leases of low-value assets. This is because each module is highly interrelated with other parts of the servers. The lessee would not lease the modules without also leasing the servers. Accordingly, the company would apply the recognition and measurement requirements of IFRS 16 to the servers.

Interactive question 2: Is it a lease?

Consider whether the following meet the criteria to be classified as leases.

Question	Fill in your answer
A company leases a laptop computer for their financial controller over a three-year period.	
A company leases a photocopier. The copier will remain on the client site, and will only be returned to the lessor in the event of a major repair.	
A company leases cars for their team of sales representatives for a three-year period. The cars are required to be estate models, but from time to time, the car may be changed by the lessor.	
A company acquires three architect's drawing desks which are paid for over 10 months. The company already has four of these desks, and no elections have been made.	

See **Answer** at the end of this chapter.

1.5 Separating components of a contract

A contract may contain both a lease component and a non-lease component. In other words, it may include an amount payable by the lessee for activities and costs that do not transfer goods or services to the lessee (IFRS 16: Para B33). These activities and costs might, for example, include maintenance, repairs or cleaning.

IFRS 16 requires entities to **account for the lease component of the contract separately from the non-lease component.** The entity must split the rental or lease payment and:

- account for the lease component under IFRS 16; and
- account for the service element separately, generally as an expense in profit or loss.

The consideration in the contract is **allocated on the basis of the stand-alone prices** of the lease component(s) and the non-lease component(s).

Context example: Separating components of a contract

Livery Co leases a delivery van from Bettalease Co for three years at £12,000 per year. This payment includes servicing costs.

Livery could lease the same make and model of van for £11,000 per year and would need to pay £2,000 a year for servicing.

Livery Co would allocate £10,154 (£12,000 × £11,000 ÷ £(11,000 + 2,000)) to the lease component and account for that as a lease under IFRS 16.

Livery Co would allocate £1,846 (£12,000 × £2,000 ÷ £(11,000 + 2,000)) to the servicing component and recognise it in profit or loss as an expense.

2 Lessee accounting

Section overview

- IFRS 16 recognises an asset and corresponding liability for all leases (unless the lease is for less than 12 months, or the underlying asset is of low value).
- A lease liability is initially recognised at the present value of future lease payments; interest accrues subsequently.
- A right-of-use asset is initially recognised at the amount of the lease liability, subject to some adjustments; it is subsequently depreciated.
- In the statement of financial position, a right-of-use asset and lease liability are recognised in respect of leased assets.
- Lease payments reduce the lease liability and cover any accrued interest.
- Interest accrues on the outstanding liability in each period of the lease.
- The finance charge is recognised in profit or loss.
- Where a contract is a lease, a right-of-use asset and a lease liability are recognised at the commencement date.

2.1 Initial measurement of the right-of-use asset

The right-of-use asset is measured at cost, which includes:

- the amount of the initial measurement of the lease liability;

- any lease payments made at or before the commencement date, less any lease incentives received;
- any initial direct costs incurred by the lessee related to the asset; and
- an estimation of any costs or penalties to be incurred by the lessee at the end of the lease term, such as dismantling costs or removal costs.

Worked example: Initial measurement of the right-of-use asset

Beta Ltd commenced a five-year lease to acquire plant on 1 January 20X8. Beta Ltd has paid an initial deposit of £800, and received lease incentives of £250. At the commencement date, the present value of the future lease payments was £12,500. Beta Ltd has incurred legal costs of acquiring the lease of £1,200. The plant will produce a new product, the XR3, and marketing costs for the new product have been incurred of £300.

At the end of the lease, Beta Ltd will have to pay £750 (at present value) to remove the plant.

Requirement

What is the initial measurement of the right-of-use asset?

Solution

Right-of-use asset

	£
PVFLP	12,500
Initial deposit	800
Direct costs	1,200
End of term costs to remove the plant	750
Less: lease incentives	(250)
Right-of-use asset	15,000

Note: The marketing costs for the new product to be made by the plant are not included as these costs are not directly attributable to the lease. This is consistent with IAS 16 (s.19(b)), where marketing costs cannot be capitalised as part of the non-current asset.

2.2 Subsequent measurement of the right-of-use asset

Subsequently, the right-of-use asset will be measured at cost less accumulated depreciation and impairment losses in line with IAS 16, *Property, Plant and Equipment*.

The right-of-use asset will be depreciated from the commencement date to the **earlier** of the end of its useful life or the end of the lease term **unless** the asset is expected to be transferred to the lessee at the end of the lease term. In that case, the asset will be depreciated over the useful life of the asset.

Worked example: Subsequent measurement of the right-of-use asset

Taking the information from the previous example, Beta has estimated that the useful life of the plant will be six years. There is no option to purchase at the end of the lease term.

Requirement

What is the carrying amount of the right-of-use asset at 31 December 20X8?

Solution

Right-of-use asset is initially measured at £15,000.

The depreciation period is the shorter of the useful life (six years) or the lease term (five years).

£15,000/5 years = £3,000 depreciation charge.

Carrying amount of the right-of-use asset at 31 December 20X8 is £12,000 (£15,000 – £3,000).

2.3 Depreciating the asset

DEBIT	Depreciation expense	The asset should be depreciated over the shorter of
CREDIT	Accumulated depreciation	the lease term or the asset's useful life

The asset should be depreciated over the shorter of the lease term or the asset's useful life.

Points to note

- Depreciation policies adopted should be consistent with other non-current assets of the same class.
- If any impairment reviews are required, these must be conducted in accordance with IAS 36, *Impairment of Assets*.
- If there is reasonable certainty that the lessee will eventually own the asset, then it should be depreciated over its estimated useful life.
- The lease term comprises the period for which the lessee has contracted to lease the asset and any further terms for which there is reasonable certainty at the inception of the lease that the lessee will exercise the option.

2.4 Initial measurement of the lease liability

At the commencement of the lease, the lease liability is measured at the **present value** of **future lease payments** including any payments expected at the end of the lease.

Lease liability will include:

- fixed payments less any lease incentives receivable;
- variable lease payments that depend on an index (eg, the consumer price index) or rate (eg, market rental rates);
- amounts expected to be payable by the lessee under residual value guarantees;
- purchase options (if reasonably certain to be exercised); and
- penalties for early termination.

The discount rate used is the interest rate implicit in the lease, or if this is not available, the lessee's incremental borrowing rate.

Definition

Lease payments: Payments made by a lessee to a lessor in order to use an underlying asset during the lease term, less any lease incentives.

IFRS 16 requires lease payments to also include the exercise price of a purchase option if the lessee is reasonably certain to exercise that option, and any penalty payments for terminating the lease.

Context example: Present value of future lease payments

Alpha Ltd has commenced a four-year lease on 1 January 20X8. Payments are £10,000 p.a. in arrears and the interest rate implicit in the lease is 10%. The present value of the future lease payments can be calculated using the PV function in excel. The PV excel function is used to calculate the present value (PV) of a series of equal cash flows (annuities). Type **=PV(** to begin the function entry then insert the rate of return required (this is the interest rate implicit in the lease), the number of periods and the payment made in each period, finally insert a closed bracket).

B4 =PV(B1,B2,B3)

	A	B
1	Rate	0.10
2	Number	4
3	payment	10,000
4	Present value of future lease payments	31,698

Therefore, at 1 January 20X8, the lease liability is measured at £31,698.

Professional skills focus: Structuring problems and solutions

Once an excel file like the one in the above example has been set up, it can be used repeatedly with different rates, lease periods and payment amounts. The structure is there and just needs to be populated with details.

2.5 Interest rate implicit in the lease

You can also use an excel file to calculate the interest rate implicit in the lease from a given payments schedule and the present value of the future lease payments.

2.6 Subsequent measurement of the lease liability

In future periods, the lease liability is amortised.

- Interest will accrue on the outstanding lease, at the rate stated in the lease contract.
- Payments made in respect of the lease by the lessee will reduce the outstanding liability.

Context example: Context example: Year 2 lease liability

Taking the example of Alpha Ltd in the previous example.

In the previous example, Alpha Ltd had calculated the initial lease liability to be £31,698 on 1 January 20X8.

Year	**£**
1.1.X8: Lease liability (PVFLP)	31,698
31.12.X8: Interest 10%	3,170
31.12.X8: Instalment in arrears	(10,000)
Liability at 31.12.X8	24,868

Therefore, at 1 January 20X9, the lease liability will be £24,868.

2.7 Setting up accounts in the statement of financial position

IFRS 16 requires that, when an asset is leased, the accounting treatment should reflect the **substance of the transaction**. In the lessee's books therefore:

DEBIT	Right-of-use asset account	The amount to be recorded in this way is the present
CREDIT	Payables: Lease liabilities	value of the future lease payments

The **initial** deposit, if any, counts as one of the lease payments and hence is included in the cost of the asset.

Points to note

- The entries are made at the **commencement** of the lease term, with the **values** determined at the start of the lease (see sections above).
- The present value of the future lease payments is derived by discounting them at the **interest rate implicit in the lease**. If it is not practicable to determine the interest rate implied in the lease, then the lessee's **incremental borrowing rate** can be used.
- Initial direct costs can be treated as part of the cost of the asset – provided they are directly attributable to activities performed by the lessee to obtain the lease.
- Although interest is payable under the lease, this is accrued over time. The justification is that the capital could, in theory, be paid off at any time, with cancellation charges. These charges could be avoided, so they are not a 'true' long term liability. **Interest is therefore recognised as it accrues**.

2.8 Making the Payment

Every period, the payments are accounted for as follows.

DEBIT Payables: Lease liabilities Each lease payment is comprised partly of a repayment of capital and partly of an interest charge
CREDIT Cash for the period.

2.9 Finance charge

The finance charge is dealt with as follows.

DEBIT	Profit or loss: Finance cost	With the amount of the interest accrued over the
CREDIT	Payables: Lease liabilities	period

2.10 Allocating the interest charge to accounting periods

IFRS 16 requires the total finance charge to be allocated to each period during the lease term so as to produce a **constant periodic rate of interest** on the outstanding lease obligation.

As the lessee pays off the capital sum, the total capital owed falls from period to period. You would therefore also expect a reduction in the total interest payable too, on the outstanding balance.

For example, if you owe £10,000 and pay 15%, the interest will be £1,500. After you have paid off, say, £8,000 of the capital, interest would be £300 (on £2,000). The monthly payments remain the same, but the mix of interest and capital changes over the life of the loan.

Therefore, in the earlier years, the finance charge (interest) is a higher proportion of the annual lease payments. Towards the end of the lease, the finance charge will be smaller as the outstanding lease liability is smaller.

2.11 Instalments in arrears

Worked example: Lease payments in arrears

A Ltd has a year-end of 31 December.

A lease commences on 1 January 20X1. Lease payments comprise three payments of £10,000 annually, commencing on 31 December 20X1.

There is no transfer of asset at the end of the lease and no purchase option. The implicit interest rate is 10%.

Requirement

You are required to calculate the interest charge and the year-end liability for each year of the lease. Round your discounted amounts to the nearest £10.

Solution

The lease liability is measured at the present value of the three payments:

B4 =PV(B1,B2,B3)

	A	B
1	Rate	0.10
2	Number	3
3	Payment	10,000
4	Present value of future lease payments	24,869

	£
20X1 balance b/f	24,869
Interest 10%	2,487
Payment 31/12/X1	(10,000)
20X2 balance b/d	17,356
Interest 10%	1,736
Payment 31/12/X2	(10,000)
20X3 balance b/d	9,092
Interest 10%	909
Payment 31/12/X3	(10,000)
	–

Note: The balance doesn't come down to exactly the outstanding amount due to rounding.

2.12 Instalments in advance

As we have seen in the examples above, interest accrues over time and is included in the payment at the end of each period of borrowing. However, where instalments are **paid in advance**:

- The first instalment **repays capital only** as no time has yet elapsed for interest to accrue.

- At the end of each accounting period the year-end liability will include **capital and interest** that has accrued to date but which has not been paid.
- The initial payment in advance (and/or any deposit) is **not included in the calculation of the lease liability. It is added to the right-of-use asset.**

Worked example: Lease payments in advance

[This is based on IFRS 16 Illustrative example 13.]

A lessee enters into a five-year lease of a building which has a remaining useful life of 10 years. Lease payments are £50,000 per annum, payable at the beginning of each year.

The lessee incurs initial direct costs of £20,000 and receives lease incentives of £5,000. There is no transfer of the asset at the end of the lease and no purchase option.

The interest rate implicit in the lease is not immediately determinable but the lessee's incremental borrowing rate is 5%.

Requirement

Calculate the initial lease liability and calculate the value of the right-of-use asset.

Solution

At the commencement date the lessee pays the initial £50,000, incurs the direct costs and receives the lease incentives. The lease liability is measured at the present value of the **remaining four payments**, ie, the **future lease payments**:

B4 =PV(B1,B2,B3)

	A	B
1	Rate	0.05
2	Number	4
3	Payment	50,000
4	Present value of future lease payments	177,297

Assets and liabilities will initially be recognised as follows:

		Debit £	Credit £
Right-of-use asset:			
Initial payment	50,000		
Discounted liability	177,297		
Initial direct costs	20,000		
Incentives received	(5,000)		
		242,297	
Lease liability			177,297
Cash	(50,000 + 20,000 – 5,000)		65,000
		242,297	242,297

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2.13 Disclosure: lease liability

IFRS 16 requires that there is presentation in the statement of financial position for the following items:

- the **right-of-use asset**
- the **lease liability**.

Right-of-use assets may be presented as a separate line item in the statement of financial position under the heading non-current assets. Alternatively, they may be included in the total of the relevant class of assets, and in this case the carrying amount of right-of-use assets is disclosed in the notes to the financial statements.

IFRS 16 makes no specific requirement to split lease liabilities between non-current and current liabilities. However, in accordance with the *Conceptual Framework's* fundamental principle of faithful representation, they should be presented in this way as best practice, so that the users of the financial statements can understand the impact of the lease liability in future years.

Interactive question 3: Payments in arrears

Using the facts from the Worked Example: Lease payments in arrears, show the presentation of the lease liability at the end of 20X1.

The lease liability working from the Worked example was as follows:

	£
20X1 balance b/f	24,869
Interest 10%	2,487
Payment 31/12/X1	(10,000)
20X2 balance b/d (current period)	17,356
Interest 10%	1,736
Payment 31/12/X2	(10,000)
20X3 balance b/d (future periods)	9,092
Interest 10%	909
Payment 31/12/X3	(10,000)

Total lease liability at 31 December 20X1 = £ [ ]

Capital > 1 year = £ [ ]

< 1 year (β) = £ [ ]

3.2 Prepare journals to show accounting entries in respect of the lease during 20X1. See

Answer at the end of this chapter.

Interactive question 4: Payments in advance

Using the facts from the Worked Example: Lease payments in advance, show the split of the lease liability at the end of year 1.

See **Answer** at the end of this chapter.

2.14 Other disclosures

Note: The leased assets and lease liabilities should not be netted off against each other.

Non-current assets

- Disclosure must be made of the carrying amount of right-of-use assets, by class of underlying asset, either on the face of the statement of financial position, or in a note.
- Depreciation charge for right-of-use assets
- Additions to right-of-use assets
- Carrying amount of right-of-use assets at the end of the reporting period by class of underlying asset
- Gains/losses resulting from any sale and leaseback transactions (see section 3)

Liabilities

- Interest expense on lease liabilities

Other disclosures

- In the case of most entities, the IAS 1, *Presentation of Financial Statements* requirement to disclose significant accounting policies would result in the disclosure of the policy in respect of leases.
- Expenses relating to short-term and low-value leases
- Total cash outflow for leases

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Interactive question 5: Summary

Summer Ltd leases an asset on 1 January 20X1. The terms of the lease are to pay a non-refundable deposit of £575 followed by seven annual instalments of £2,000 payable in arrears. The asset is expected to have a useful life of seven years.

The present value of the future lease payments (excluding the deposit) is £11,164. There is no option to purchase the asset at the end of the lease term.

The interest rate implicit in the lease is 6%.

Requirement

Calculate the value of the lease liability and the right-of-use asset at 31 December 20X1 and 31 December 20X2.

Note: (Round your answers to the nearest pound)

See **Answer** at the end of this chapter.

Professional skills focus: Applying judgement

IFRS 16 has tightened the rules on leasing to the extent that there is limited scope for judgement. The standard was brought in to remedy abuses and loopholes. However, there remains some scope, for example in electing to show potentially exempt leases in the statement of financial position, or in the estimation of the useful economic life of the underlying asset.

3 Sale and leaseback transactions

Section overview

- A sale and leaseback transaction involves the sale of an asset and the subsequent leasing back of the same asset.
- The treatment of a sale and leaseback transaction will depend on whether the transfer is a sale as defined by IFRS 15, *Revenue from Contracts with Customers*.

3.1 Introduction

Companies can raise finance in a number of different ways. These include short-term measures such as a bank overdraft, medium-term measures such as loans or leases and longer-term measures including secured loans.

Another option is a **sale and leaseback transaction**. This is a common feature of certain industries, including retailing and hotels. It involves **the original owner of the asset selling it**, typically to a finance house or bank, **and immediately leasing it back**, thereby raising cash and retaining the use of the asset. Such arrangements provide entities with the opportunity to release capital caught up in the business for investment in other opportunities or to return it to shareholders. In essence, an entity acquires cash in exchange for a commitment to make regular lease payments without losing use of the asset.

Under IFRS 16, the key initial assessment is whether or not the transfer of the asset constitutes a genuine sale. For this to be the case, the requirements of IFRS 15, *Revenue from Contracts with Customers* for determining when a performance obligation is satisfied must be met.

3.2 IFRS 15 criteria for a sale

The transfer of an asset qualifies as a sale if the customer obtains **control** of the asset. In determining this, the following should be considered (IFRS 15, para. 38):

(a) Whether the selling entity has a present right to payment for the asset

(b) Whether the selling entity has transferred legal title to the asset

(c) Whether the selling entity has transferred physical possession of the asset

(d) Whether the selling entity has transferred the risks and rewards of ownership of the asset to the customer

(e) Whether the purchaser has accepted the asset

Criterion 4, relating to the risks and rewards of ownership, is likely to be the most important of the above criteria in considering whether control has passed to the customer and therefore whether the IFRS 15 criteria for a sale have been satisfied.

Context example: Transfer is a sale (1)

[This is based on IFRS 16 Illustrative example 13.]

A lessee enters into a five-year lease of a building which has a remaining useful life of 10 years. Lease payments are £50,000 per annum, payable at the beginning of each year.

If the transfer of the asset is a sale:

Stage 1

The seller/lessee measures the **right-of-use asset arising from the leaseback** as a proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller/lessee:

Carrying amount × (PV of future lease payments at transfer date ÷ Fair value of asset at transfer date)

Stage 2

The seller/lessee only recognises the **amount of any gain or loss** on the sale that relates to the **rights transferred to the buyer**.

Calculating the gain or loss on sale:

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Calculate the total gain on the sale:

	£
Fair value	X
Less: carrying amount	(X)
Total gain/(loss) on the sale	X/(X)

Then **determine the gain** that relates to the rights retained

Gain × (PV of future lease payments ÷ Fair value of asset at transfer date) = Gain related to rights retained

Stage 3

The gain relating to the rights transferred is the balancing figure:

Gain on rights transferred = total gain (W1) – gain on rights retained (W2)

The right-of-use asset continues to be depreciated as normal, although there may be a revision of the useful life required (see 2.3).

Worked example: Transfer is a sale (2)

Hill plc owned a machine with a carrying amount of £5,040,000 on 1 July 20X5. On this date Hill plc sold the property to Dale plc for £7,920,000, which was the fair value of the machine, and then undertook to lease it back under a 20-year lease. Annual lease payments were £240,000 in arrears and the present value of future lease payments at the 6% interest rate implicit in the lease was £2,752,800 at 1 July 20X5.

The machine was transferred to Dale plc's premises, but Hill plc has the right to use it. Hill plc has no option to repurchase the machine at the end of the lease period.

Requirement

How should the transaction be accounted for by Hill plc in the year ended 30 June 20X6?

Solution

The fact that the machine has been transferred to the new lessor's premises, and the fact that Hill plc has no right to repurchase the machine both indicate that control has transferred to Dale plc, and that this qualifies as a sale under IFRS 15.

Part of the carrying amount of the asset is allocated to be a right-of-use asset retained. This is calculated based on the right-of-use asset (lease liability) as a proportion of fair value:

Right of use asset = £5,040,000 × (2,752,800 ÷ 7,920,000) = £1,751782

The remaining carrying amount of £3,288,218 (5,040,000 – 1,751,782) represents the transferred asset.

The overall gain on disposal is £2,880,000 (£7,920,000 – 5,040,000); only that part of the gain relating to the transferred asset is recognised:

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Gain relating to retained rights = £2,880,000 × (2,752,800 ÷ 7,920,000) = £1,001,018

Therefore the recognised gain relating to the transferred rights is £1,878,982 (2,880,000 – 1,001,018).

At 1 July 20X5, the following entries are required:

DEBIT	Right-of-use asset	£1,751,782	
DEBIT	Bank	£7,920,000	
CREDIT	PPE		£5,040,000
CREDIT	Gain on disposal		£1,878,982
CREDIT	Lease liability		£2,752,800

The right-of-use asset is subsequently depreciated over the lease term of 20 years; therefore in the year ended 30 June 20X6:

DEBIT	Depreciation expense (1,751,782/20)	£87,589	
CREDIT	Right-of-use asset		£87,589

The lease liability is amortised:

	£
1 July 20X5	2,752,800
Interest at 6%	165,168
Lease payment	(240,000)
28 June 20X6	2,677,968

Amortisation for the year ended 30 June 20X6 is recognised by: £87,589

DEBIT	Finance charge	£165,168	
DEBIT	Lease liability	£74,832	
CREDIT	Bank		£240,000

Interactive question 6: Sale and leaseback where the transfer is a sale

Frayn plc sold an asset (with a carrying amount at 31 December 20X0 of £70,000) and entered into a sale and leaseback arrangement on 1 January 20X1, when:

- the sale proceeds were at fair value of £120,000
- the remaining useful life of the asset was four years

The lease provided for five annual rentals of £25,000 payable in arrears on 31 December of each year. The interest rate implicit in the lease was 5% and the present value of the future lease payments was £108,225.

Requirement

Set out the journal entries at the date of disposal and calculate the amounts to be recognised in profit or loss in the year to 31 December 20X1 and in the statement of financial position at that date.

See **Answer** at the end of this chapter.

Professional skills focus: Structuring problems and solutions

Sale and leaseback is a clear illustration of the importance of structuring your approach. Use the three-stage process above to focus your answer.

3.3 Transfer is not a sale

If the transfer is not a sale under IFRS 15, *Revenue from Contracts with Customers*, ie, the performance obligation is not satisfied, then the seller/lessee will continue to recognise the transferred asset and also recognises a financial liability equal to the transfer proceeds, accounting for it using IFRS 9, *Financial Instruments*.

The treatment is reversed in the books of the buyer/lessor:

Seller/lessee	Buyer/lessor
Continue to recognise the transferred asset	No physical asset recognised
Recognise a financial liability measured at transfer proceeds	Recognise a financial asset measured at transfer proceeds

Worked example: Transfer is a not a sale

Green plc has a year end of 31 December. The company owned a machine with a carrying amount of £720,000 on 1 January 20X3. On this date Green plc sold the machine to Blue Bank plc for £480,000, and then undertook to lease it back under a five-year lease. The asset is retained at Green plc's premises and the company continues to use it. Green plc is also responsible for insuring the machine.

The annual rental is £120,000 payable in arrears and the interest rate implicit in the lease is 8%.

Requirements

1 Show how this transaction should be accounted for by Green plc.

2 Show the journal entries in relation to this transaction for the year ended 31 December 20X3.

Solution

1 Green plc retains the machine at its premises and continues to use it. Green plc also insures the machine, which means that the risks and rewards of ownership have not been transferred to the customer. Both these matters indicate that the buyer has not obtained control of the machine and therefore that the transfer is not a sale in accordance with IFRS 15.

Therefore on 1 January 20X3 the sale proceeds are recognised as a financial liability as follows:

At the date of sale/inception of the lease

DEBIT	Cash	£480,000	
CREDIT	Financial liability		£480,000

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The liability is accounted for in line with IFRS 9 at amortised cost (because it is not held for trading):

Year ended	B/f	Interest at 8%	Payment	C/f
	£	£	£	£
31 December 20X3	480,000	38,400	(120,000)	398,400
31 December 20X4	398,400	31,872	(120,000)	310,272
31 December 20X5	310,272	24,822	(120,000)	215,222
31 December 20X6	215,222	17,218	(120,000)	112,439
31 December 20X7	112,439	8,995*	(120,000)	–

* rounding difference £1,434

2 In the year ended 31 December 20X3, the amortisation of the liability is recognised as follows:

At the date of sale/inception of the lease

DEBIT	Financial liability	£81,600	
DEBIT	Finance charge	£38,400	
CREDIT	Bank		£120,000

3.4 Transfer is a sale not on market terms

If the fair value of the consideration for the sale does not equal the fair value of the asset, or if the lease payments are not at market rates, adjustments should be made to the accounting entries as this is deemed to be a method of additional financing:

Below market terms	Above market terms
Treat as a prepayment of lease payments	Treat as additional financing by the lessor/buyer
	Adjust the PVFLP by the excess of consideration over the fair value of the asset

In practice the consideration for the sale is much more likely to be above market terms, and this is the scenario that will be tested in the exam. IFRS 16 gives detailed guidance on this situation. A sale below market price is unlikely to happen, and may even be an indicator of fraud.

Worked example: Sale and leaseback not at market rates

Sydney plc has a year end of 31 December.

The company sold a building on 1 January 20X5 for £1.2 million. The fair value of the building was £1 million.

The carrying amount of the building at 31 December 20X4 was £900,000.

Sydney plc arranges to leaseback the building for a period of six years, and the remaining useful life of the building is 20 years.

The lease payments will be made in arrears starting 31 December 20X5 of £180,000 p.a. The implicit interest rate of the lease is 5%.

Requirement

Produce the journal entries for the financial statements as at 31 December 20X5 reflecting the above transactions.

Solution **Step 1**

Calculate the value of the lease liability

The present value of future lease payments is £913,625 (W1).

However, the consideration (£1,200,000) was in excess of the fair value (£1,000,000). This excess of
£200,000 is considered as additional financing, therefore:

PVFLP = £913,625

Consideration > FV of asset

Lease liability £713,625

Step 2

Calculate the right-of-use asset

Carrying amount × (PVFLP ÷ FV) (adjusted for excess consideration)

£900,000 × (£713,625 ÷ £1,000,000) = £642,262

Initial measurement of the right-of-use asset is £642,262.

Depreciation will be charged over six years as this is the shorter of the useful life (20 years) and the lease term (six years).

Therefore, charge for year ended 31 December 20X5 is £642,262/6 = £107,044.

Step 3

Calculate the gain on sale and leaseback

The gain is calculated based on the fair value of the transferred asset rather than full proceeds. Sydney plc can only recognise the amount of gain relating to the rights transferred.

- Stage 1 (calculate the gain): £1,000,000 – £900,000 = £100,000
- Stage 2 (gain relating to rights retained): £100,000 × £713,625/£1,000,000 = £71,363
- Stage 3 (gain on the rights transferred): £100,000 – £71,363 = £28,637

Journal entry

		£	£
DEBIT	Cash	1,200,000	
DEBIT	Depreciation expense	107,044	
DEBIT	Right-of-use asset	642,262	
CREDIT	Building (carrying amount)		900,000
CREDIT	Accumulated depreciation		107,044
CREDIT	Lease liability		913,625
CREDIT	Gain on rights transferred		28,637
		1,949,306	1,949,306

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Lease payment	Discount	£
180,000	1.05^1	171,429
180,000	1.05^2	163,265
180,000	1.05^3	155,491
180,000	1.05^4	148,086
180,000	1.05^5	141,035
180,000	1.05^6	134,319
Total PVFLP		913,625

Interactive question 7: Sale and leaseback

On 1 April 20X2, Wigton Co bought an injection moulding machine for £600,000. The carrying amount of the machine as at 31 March 20X3 was £500,000. On 1 April 20X3, Wigton Co sold it to Whitehaven Co for £740,000, its fair value. Wigton Co immediately leased the machine back for five years, the remainder of its useful life, at £160,000 per annum payable in arrears. The present value of the annual lease payments is £700,000 and the transaction satisfies the IFRS 15 criteria to be recognised as a sale.

Requirement

What gain or loss should Wigton Co recognise for the year ended 31 March 20X4 as a result of the sale and leaseback?

See **Answer** at the end of this chapter.

4 Lessor accounting

Section overview

- For **lessor accounting**, IFRS 16 **makes a distinction between finance leases and operating leases**.
- **Finance leases:** record the amount due to the lessor in the statement of financial position at the net investment in the lease, recognise finance income to give a constant periodic rate of return.
- **Operating leases:** record the asset as a non-current asset and depreciate over useful life, record income on a straight-line basis over the lease term.

Tutorial Note

You have not studied lessor accounting at Professional Level, so all the material in this section must be studied carefully.

4.1 Introduction

Several definitions are relevant to lessor accounting in particular, all from IFRS 16 Appendix A.

Definitions

Finance lease: A lease that transfers substantially all the risks and rewards incidental to ownership of an underlying asset.

Operating lease: A lease that does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

Unguaranteed residual value: That portion of the residual value of the underlying asset, the realisation of which by the lessor is not assured or is guaranteed solely by a party related to the lessor.

Gross investment in the lease: The sum of:

(a) the lease payments receivable by the lessor under a finance lease; and

(b) any unguaranteed residual value accruing to the lessor.

Net investment in the lease: The gross investment in the lease discounted at the interest rate implicit in the lease.

Unearned finance income: The difference between:

(a) the gross investment in the lease; and

(b) the net investment in the lease.

4.2 Risks and rewards

The classification of leases is based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessee or the lessor. When we talk of **risks** here, we specifically mean the risks of ownership, not other types of risk. Risks of **ownership** include the possibility of losses from idle capacity or technological obsolescence, or variations in return due to changing economic conditions. The **rewards** are represented by the expectation of profitable operation over the asset's economic life, and also any gain from appreciation in value or realisation of a residual value.

There are some specific examples that suggest a finance lease such as the lessee receives ownership of the asset at the end of the lease term, the lessee is expected to exercise the option to purchase, the lease term forms the majority of the asset's economic life, the asset is substantially loaned whereby the present value of lease payments is almost all of the fair value of the asset and/or the asset is specialised for use by the lessee or entities authorised by the lessee.

When a lease includes both **land and building** elements, the classification of each element as an operating or finance lease should be made separately. In determining whether the land element is an operating or finance lease, an important consideration is that land normally has an indefinite economic life.

4.3 Operating leases

A lessor continues to recognise an asset that is leased out by way of an operating lease, and charges depreciation over the useful life of the asset. Lease income from the operating lease is recognised on a straight-line basis over the lease term, unless another systematic and rational basis is more representative of the time pattern in which the benefit from the leased asset is receivable.

The cost of incentives provided to the lessee is recognised as a reduction of the rental income over the lease term, generally on a straight-line basis.

If a lessor incurs costs to negotiate and arrange an operating lease, these costs are capitalised within the carrying amount of the underlying asset that is the subject of the lease. They are amortised over the lease term on the same basis as lease income.

Worked example: Operating lease

At 1 April 20X3, SupaTruck plc owns a tow truck costing £75,000 with an economic life of 10 years. The company entered into a two years lease agreement to lease the truck to Dimble Recovery plc for £10,000 per year. SupaTruck continues to retain ownership of the tow truck and charges depreciation on a straight line basis, with no residual value.

Requirement

What journal entries should SupaTruck record in the year ended 31 March 20X4?

Solution

SupaTruck recognises a non-current asset at historical cost less depreciation at year-end. The depreciation charge is £75,000/10 years = £7,500 and rental income of £10,000 is also recognised with appropriate disclosures.

The required journal entries in the year ended 31 March 20X4 are (£):

		£	£
DEBIT	Depreciation expense	7,500	
CREDIT	PPE (accumulated depreciation)		7,500
and			
DEBIT	Cash/receivable	10,000	
CREDIT	Rental income		10,000

4.4 Finance leases

Although a lessor is the legal owner of an asset leased to another party under a finance lease, it has passed the risks and rewards of ownership to the lessee in return for a cash flow stream. As a result, the lessor derecognises the asset and instead recognises a receivable equal to the net investment in the lease. This is the present value of the aggregate of:

(a) the lease payments receivable by the lessor; and

(b) any unguaranteed residual amount accruing to the lessor.

An unguaranteed residual amount is that part of the residual value of a leased asset that is not assured or is guaranteed only by a party related to the lessor.

Initial direct costs incurred in negotiating and arranging the lease are added to the receivable.

Upon receipt of cash payments from the lessee, the amount received is allocated between the repayment of principal and finance income. The finance income should be recognised so as to generate a constant periodic rate of return on the outstanding net investment.

Worked example: Finance lease

Leighton Machinery plc leased a machine to a customer with effect from 1 January 20X4. The fair value of the machine at this date (equal to the net investment in the lease) was £14,875 and arrangement fees amounted to £125. The lease term was eight years and rentals of £2,750 are payable annually in advance. The interest rate implicit in the lease is 12.8%.

Requirement

What amounts are recognised in Leighton Machinery's financial statements in the year ended 31 December 20X4 in respect of the lease?

Solution

The receivable is initially recognised at £14,875 + £125 = £15,000.

Interest accrues to the receivable and payments reduce it as follows over the first two years of the term:

y/e	Balance b/f	Repayment	Balance c/f	Finance income	Balance c/f
	£	£	£	£	£
31.12.X4	15,000	(2,750)	12,250	1,568	13,818
31.12.X5	13,818	(2,750)	11,068	1,417	12,485

Therefore in the statement of financial position of Leighton Machinery, a current and non-current asset are recognised.

Non-current asset: Net investment in finance lease: £11,068 Current asset: Net investment in finance lease: £2,750

Interest receivable of £1,568 is recognised in the statement of profit or loss and other comprehensive income.

4.4.1 Summary

For lessor accounting, IFRS 16 makes a distinction between finance leases and operating leases.

5 IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*

Section overview

This section gives a very brief overview of the material covered in earlier studies.

Definitions

Government assistance: Action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria.

Government grants: Assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

Grants related to assets: Government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets.

Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

Grants related to income: Government grants other than those related to assets.

Forgivable loans: Loans which the lender undertakes to waive repayment of under certain prescribed conditions.

Accounting treatment

- **Recognise government grants and forgivable loans** once conditions complied with and receipt/waiver is assured.
- Grants are recognised under the **income approach**: recognise grants as income to match them with related costs that they have been received to compensate.
- Use a **systematic basis** of matching over the relevant periods.
- Grants for **depreciable assets** should be recognised as income on the same basis as the asset is depreciated.
- Grants for **non-depreciable assets** should be recognised as income over the periods in which the cost of meeting the obligation is incurred.
- A grant may be **split into parts** and allocated on different bases where there are a series of conditions attached.
- Where **related costs have already been incurred**, the grant may be recognised as income in full immediately.
- A grant in the form of a **non-monetary asset** may be valued at fair value or a nominal value.
- **Grants related to assets** may be presented in the statement of financial position **either** as **deferred incomeor** deducted in arriving at the carrying value of the asset.
- **Grants related to income** may be presented in the statement of profit or loss and other comprehensive income (in profit or loss) **either** as a **separate creditordeducted** from the related expense.
- Repayment of government grants should be accounted for as a **revision of an accounting estimate**.

Disclosure

- **Accounting policy** note
- **Nature and extent** of government grants and other forms of assistance received
- **Unfulfilled conditions** and other contingencies attached to recognised government assistance

Interactive question 8: Government grants

IAS 20 suggests that there are two approaches to recognising government grants: a capital approach (credit directly to shareholders' interests) and an income approach. IAS 20 requires the use of the income approach.

Requirement

What are the arguments in support of each method? See **Answer** at the end of this chapter.

---

6 IAS 23, *Borrowing Costs*

Section overview

- This section gives a very brief overview of the material covered in earlier studies.
- IAS 23 deals with the treatment of borrowing costs, often associated with the construction of **self- constructed assets**, but which can also be applied to an asset purchased that takes time to get ready for use/sale.

Definitions

Borrowing costs: Interest and other costs incurred by an entity in connection with the borrowing of funds.

Qualifying asset: An asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

6.1 Accounting treatment

Note the following key points, which should be familiar from your earlier studies.

- Borrowing costs must be **capitalised** as part of the cost of the asset if they are directly attributable to acquisition/construction/production. Other borrowing costs must be expensed.
- **Borrowing costs eligible for capitalisation** are those that would have been avoided otherwise. Use judgement where a range of debt instruments is held for general finance.
- **Amount of borrowing costs available for capitalisation** is actual borrowing costs incurred less any investment income from temporary investment of those borrowings.
- For borrowings obtained generally, apply the **capitalisation rate** to the expenditure on the asset (weighted average borrowing cost). It must not exceed actual borrowing costs.
- **Capitalisation is suspended** if active development is interrupted for extended periods. (Temporary delays or technical/administrative work will not cause suspension.)
- **Capitalisation ceases** (normally) when physical construction of the asset is completed. When an asset is comprised of separate stages, capitalisation should cease when each stage or part is completed.
- Where the recoverable amount of the asset falls below carrying amount, it must be **written down/off**.

6.2 Disclosure

- Amount of **borrowing costs capitalised** during the period
- **Capitalisation rate** used to determine borrowing costs eligible for capitalisation

Interactive question 9: Borrowing costs 1

On 1 January 20X8, Rechno Co borrowed £15 million to finance the production of two assets, both of which were expected to take a year to build. Production started during 20X8. The loan facility was drawn down on 1 January 20X8 and was used as follows, with the remaining funds invested temporarily.

	Asset X	Asset Y
	£m	£m
1 January 20X8	2.5	5.0
1 July 20X8	2.5	5.0

The loan rate was 10% and Rechno Co can invest surplus funds at 8%.

Requirement

Ignoring compound interest, calculate the borrowing costs which must be capitalised for each of the assets and consequently the cost of each asset as at 31 December 20X8.

See **Answer** at the end of this chapter.

Interactive question 10: Borrowing costs 2

Zenzi Co had the following loans in place at the beginning and end of 20X8.

	1 January 20X8	31 December 20X8
	£m	£m
10.0% bank loan repayable 20Y3	120	120
9.5% bank loan repayable 20Y1	80	80
8.9% debenture repayable 20Y8	–	150

The 8.9% debenture was issued to fund the construction of a qualifying asset (a piece of mining equipment), construction of which began on 1 July 20X8.

On 1 January 20X8, Zenzi Co began construction of a qualifying asset, a piece of machinery for a hydroelectric plant, using existing borrowings. Expenditure drawn down for the construction was:
£30 million on 1 January 20X8, £20 million on 1 October 20X8.

Requirement

Calculate the borrowing costs to be capitalised for the hydroelectric plant machine. See

Answer at the end of this chapter.

7 Statements of cash flows

Section overview

This section briefly revises single company statements of cash flows, which was covered at Professional Level. Try the interactive questions here to make sure you are comfortable with this topic before revising consolidated statements of cash flows in later Chapters.

7.1 Basic statements of cash flows – revision

(a) A statement of cash flows prepared in accordance with IAS 7, *Statement of Cash Flows* provides information about the historical changes in an entity's cash and cash equivalents. This information is presented in a statement that classifies cash flows between operating activities, investing activities and financing activities.

(b) Cash, as defined in IAS 7, includes not only cash itself but also any instrument that can be converted into cash so quickly that it is in effect equivalent to cash.

(c) 'Operating activities' are the principal revenue-generating activities of an entity, together with any other activities which are not identified as being investing or financing in nature.

(d) The cash flows from an entity's operating activities can be presented using two methods:

(1) The **direct method**, which discloses the major classes of gross cash receipts and payments; or

(2) The **indirect method**, where the entity starts with the net profit or loss for the period and adjusts it for non-cash transactions, deferrals or accruals of income and expenditure and items that will form part of the entity's investing and financing activities.

(e) 'Investing activities' are acquisitions and disposals of long-term assets and investments, other than cash and cash equivalents. Examples include: cash paid or received to acquire or sell an item of property, plant or equipment, a receipt of cash from the sale of a business, and cash advanced as a loan to another entity.

(f) 'Financing activities' are activities that change the amount and composition of an entity's equity capital and borrowings. Examples include: cash proceeds from issuing shares, cash paid to repay debt instruments, and the capital element in a finance lease payment.

(g) Investing and financing activities that do not impact on cash, for example the conversion of debt to equity, should not be included in the statement of cash flows.

Interactive question 11: Single company statement of cash flows

Elida is a publicly listed company. The following financial statements of Elida are available:

Statement of profit or loss and other comprehensive income for year ended 31 March 20X8

	£'000
Revenue	5,740
Cost of sales	(4,840)
Gross profit	900
Income from and gains on investment property	60
Distribution costs	(120)
Administrative expenses (Note (ii))	(350)
Finance costs	(50)
Profit before tax	440
Income tax expense	(160)
Profit for the year	280
Other comprehensive income	
Gains on property revaluation	100
Total comprehensive income	380

Statements of financial position as at:

	31 March 20X8		31 March 20X7	
	£'000	£'000	£'000	£'000
ASSETS				
Non-current assets (Note (1))				
Property, plant and equipment		2,880		1,860
Investment property		420		400
		3,300		2,260
Current assets				
Inventory	1,210		810	
Trade receivables	480		540	
Income tax asset	nil		50	
Bank	10	1,700	nil	1,400
Total assets		5,000		3,660
EQUITY AND LIABILITIES				
Equity				
Equity shares of 20p each (Note (3))		1,000		600
Share premium	600		nil	
Revaluation reserve	150		50	
Retained earnings	1,440	2,190	1,310	1,360
		3,190		1,960
Non-current liabilities				
6% loan notes (Note (2))	nil		400	
Deferred tax	50	50	30	430
Current liabilities				
Trade payables	1,410		1,050	
Bank overdraft	nil		120	
Warranty provision (Note (4))	200		100	
Current tax payable	150	1,760	nil	1,270
Total equity and liabilities		5,000		3,660

The following supporting information is available:

(1) An item of plant with a carrying amount of £240,000 was sold at a loss of £90,000 during the year. Depreciation of £280,000 was charged (to cost of sales) for property, plant and equipment in the year ended 31 March 20X8.

Elida uses the fair value model in IAS 40, *Investment Property*. There were no purchases or sales of investment property during the year.

(2) The 6% loan notes were redeemed early incurring a penalty payment of £20,000 which has been charged as an administrative expense in the statement of profit or loss.

(3) There was an issue of shares for cash on 1 October 20X7. There were no bonus issues of shares during the year.

(4) Elida gives a 12-month warranty on some of the products it sells. The amounts shown in current liabilities as warranty provision are an accurate assessment, based on past

experience, of the amount of claims likely to be made in respect of warranties outstanding at each year end. Warranty costs are included in cost of sales.

(5) A dividend of 3p per share was paid on 1 January 20X8.

Requirement

Prepare a statement of cash flows for Elida for the year to 31 March 20X8 in accordance with IAS 7, *Statement of Cash Flows*.

See **Answer** at the end of this chapter.

8 Audit focus

Section overview

Matters that the auditor should consider when auditing leases for lessees include:

- correctly identifying whether a lease exists;
- confirming the amounts to be included in the financial statements; and
- whether the disclosure is in line with applicable accounting standards.

Auditing issues for lessors require the distinction between operating and finance leases.

8.1 Auditing leases for lessees

In auditing leases recognised at fair value (eg, investment properties), the auditor must evaluate whether the fair value is appropriate. We will cover the auditing of fair value in further detail in the Audit Focus Sections in later Chapters.

The table below summarises the areas of audit focus when auditing leases in accordance with IFRS 16, and provides some examples of audit evidence required.

Issue	Evidence
Identifying right-of-use assets	As the key test here is correctly identifying an asset as a right-of-use asset, the auditor should consider the following: • Obtain contract for relevant assets and determine whether lessee has control (via evidence of receiving economic benefits and the ability to direct the use of the asset concerned) • Review assets for any below the threshold (eg, $5,000 or 12 months in duration) to determine any exemptions • Review contracts for any separate components (such as maintenance contracts) and confirm each component is separately identified and the correct costs are used
Confirming the **correct accounting treatment** of right-of-use assets	Obtain details of the costs of any leased right-of-use assets and confirm they include attributable costs (such as incentives or advance payments) by reference to terms of contract and any supporting transactions Confirm correct treatment of recognition throughout the asset's life by challenging management on the depreciation policy used (for example, is the asset life appropriate?)

Lease **liabilities**	Amounts recognised as liabilities should be confirmed by reference to the contract and challenged for attributable amounts (such as amounts paid in advance or arrears)
Sale and leaseback arrangements	As these are likely to be complex, auditors should obtain an understanding of the sale and leaseback arrangements via the contract and the client to ensure they reflect the reality of the transaction (for example, does it satisfy the IFRS 15 conditions required to be recognised as a sale?)
Disclosure in the financial statements	Review the IFRS 16 disclosures in the financial statements to determine whether they are consistent and complete

8.2 Auditing leases for lessors

Central to the work of the auditor for a lessor is being able to confirm whether any leases are finance or operating leases. The key procedure here is to obtain a copy of the contract in place for any such lease and to confirm who bears the ultimate risk and reward (the contract will not specify this, so the auditor will need to consider this by analysing the terms stated).

8.3 Further auditing issues

- Financial statements may be deliberately misstated to present short term or low value assets inappropriately to avoid the need to show lease liabilities.
- Sale and leaseback arrangements require an accounting treatment that supports IFRS 15 and auditors will need to ensure their clients have followed this treatment in such cases.

Summary

Leases (IFRS 16)

A contract, or part of a contract, that conveys the right to use an asset, the underlying asset, for a period of time in exchange for consideration.

Identifying a lease

- Identified asset
- Period of time
- In exchange for consideration
- Right to control:
  - substantially all economic benefits from use
  - direct the use

Exemptions from standard lessee accounting model

- Low value assets (election by class of asset)
- Lease <12 months (election lease by lease basis)

Lease liability

Lease liability includes

- Fixed payments
- Variable payments (related to index/rate)
- Amounts paid under residual value guarantee
- Purchase options (if reasonably certain to exercise)
  LESS
- Lease incentives

Discount at rate implicit in the lease (lessee's incremental borrowing rate) to give PVFLP

Right-of-use asset

Initial measurement PVFLP +/- adjustments = RoU asset

Subsequent periods:

- Cost less depreciation less impairment
- IAS 16 applies (revaluation model); OR
- IAS 40 (fair value model)

Sale and leaseback

Sale under IFRS 15

Derecognise rights transferred and recognise associated gain/loss.
Transfer retained rights to be right-of-use asset and recognise liability.

Not a sale (IFRS 15)

Financing arrangement (IFRS 9)

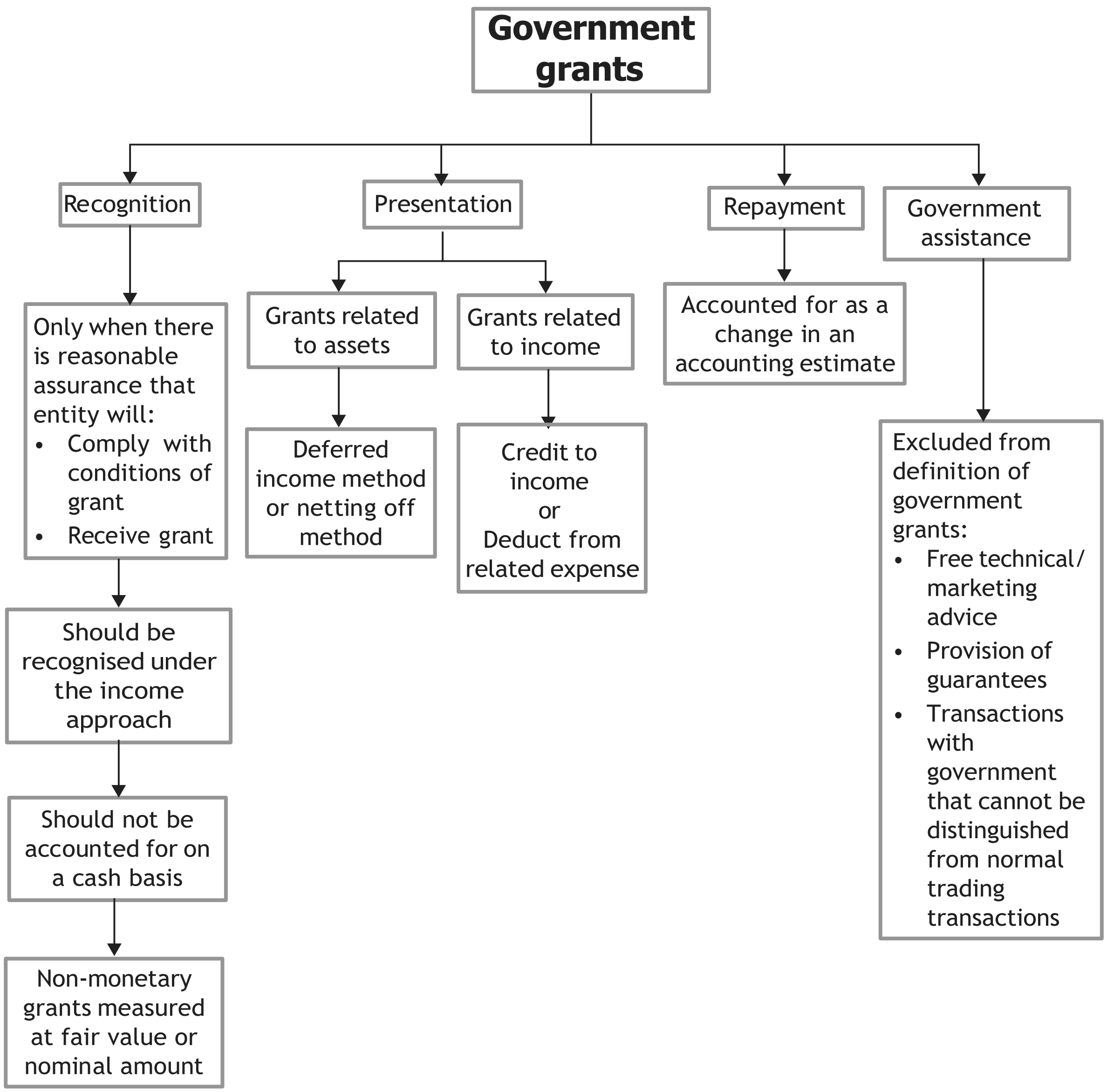
Lessor accounting

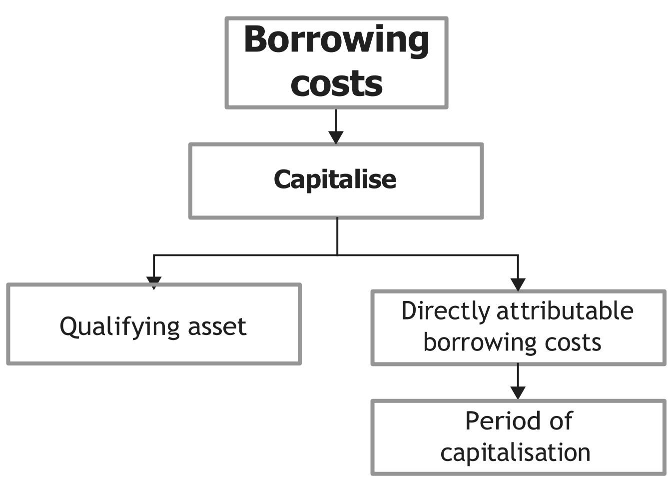
Finance lease

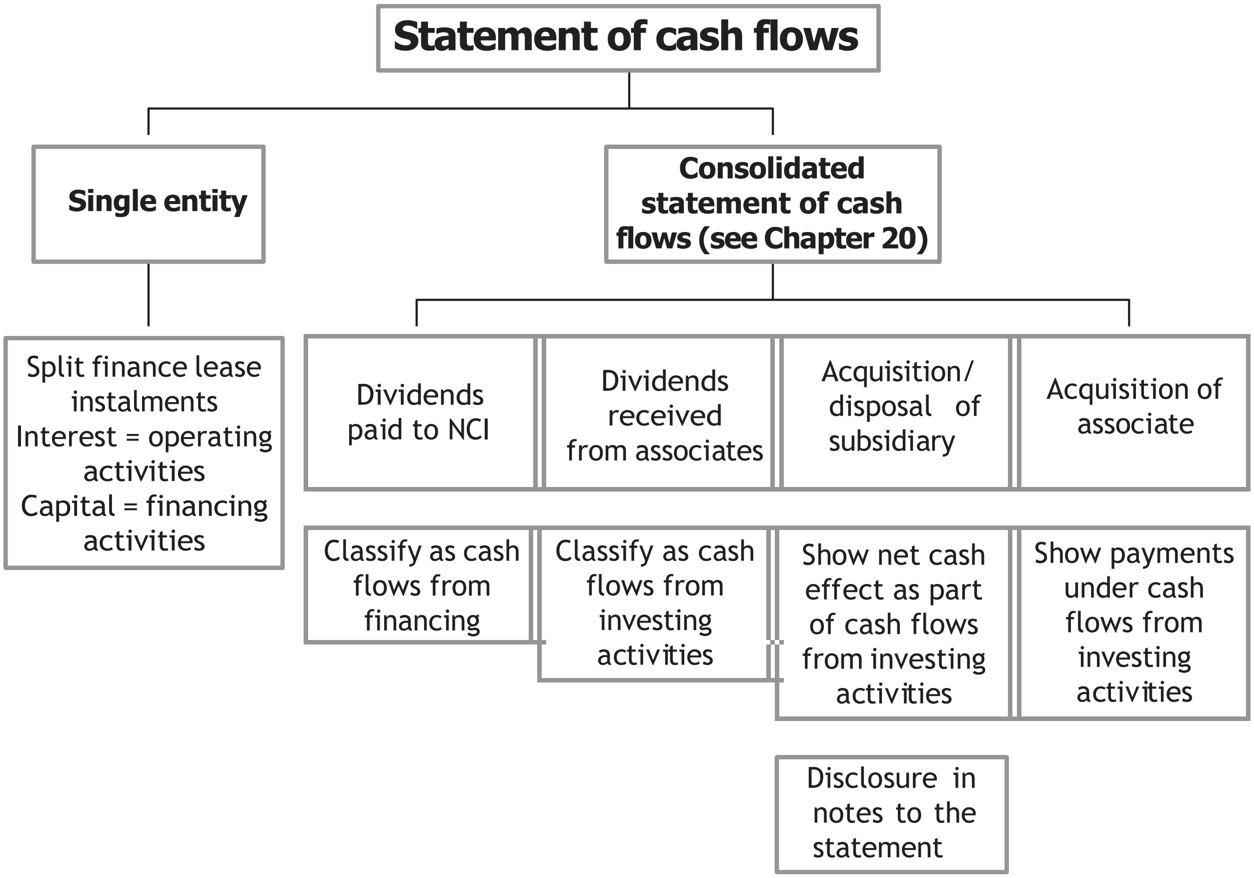
- Lease that transfers substantially all the risks and rewards of ownership
- Derecognise asset
- Set up a receivable at the net investment in the lease
- Receipts - split between finance income and capital

Operating lease

- A lease that does not transfer substantially all the risks and rewards of ownership
- Retain asset in the books of the lessor
- Credit rentals to P/L straight line over lease term or other systematic basis


Government grants
Recognition
Presentation
Repayment
Government assistance
Only when there is reasonable assurance that entity will:
• Comply with conditions of grant
• Receive grant
Grants related to assets
Grants related to income
Accounted for as a change in an accounting estimate
Deferred income method or netting off method
Credit to income or Deduct from related expense
Excluded from definition of government grants:
• Free technical/ marketing advice
• Provision of guarantees
• Transactions with government that cannot be distinguished from normal trading transactions
Should be recognised under the income approach
Should not be accounted for on a cash basis
Non-monetary grants measured at fair value or nominal amount


Borrowing costs
Capitalise
Qualifying asset
Directly attributable borrowing costs
Period of capitalisation


Statement of cash flows
Single entity
Consolidated statement of cash flows (see Chapter 20)
Split finance lease instalments Interest = operating activities Capital = financing activities
Dividends paid to NCI
Dividends received from associates
Acquisition/ disposal of subsidiary
Acquisition of associate
Classify as cash flows from financing
Classify as cash flows from investing activities
Show net cash effect as part of cash flows from investing activities
Show payments under cash flows from investing activities
Disclosure in notes to the statement

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	What is meant by 'control' in the context of IFRS 16, *Leases?* (Topic 1)
2.	Can you identify a lease as defined in IFRS 16? (Topic 1)
3.	How should the right-of-use asset be measured on initial recognition and subsequently? (Topic 2)
4.	How should the lease liability be measured on initial recognition and subsequently? (Topic 2)
5.	Can you account for sale and leaseback transactions? (Topic 3)
6.	How does lessor accounting differ from lessee accounting? (Topic 4)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Isaac	This is a useful leasing question, because you are asked for the total charge to profit or loss without being told how this is made up.
Snow	Here you are tested on two aspects of leasing that regularly come up: the carrying amount of the right-of-use asset and sale and leaseback.
Noname	This recaps provisions and emphasises that the treatment of onerous leases falls under IFRS 16, rather than IAS 37.
Tonto	The single company statement of cash flows is revised from your earlier studies, in preparation for consolidated statements of cash flows introduced in a later chapter.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios to help you improve knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Telo (note 3 issue only)	This deals with lessor accounting, which is less commonly tested than lessee accounting.
Solvit (sale and leaseback only)	You have answered other parts of this question in earlier chapters. The issue of sale and leaseback gets tested regularly and the calculations will get easy with practice.
UHN (issue 1 only)	This tests a more complicated sale and leaseback. Note that you are later required to show the impact of this and other adjustments on the gearing and interest cover ratio, but you can't do this just from one adjustment.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving onto the next chapter.

Technical references

1 IFRS 16, *Leases*

(1) **Identification of a lease**

- An assessment of whether the contract contains a lease by considering the following elements: – **IFRS 16 (9)**
  - A right to control an asset – **IFRS 16 (B24)**
  - Use of an identified asset – **IFRS 16 (B13)**
  - Use for a period of time in exchange for consideration – **IFRS 16 (10)**
  - At the commencement date, the lessee shall recognise a 'right-of-use' asset – **IFRS 16 (23)**

(2) **Measurement**

- Initial measurement of the right-of-use asset includes: – **IFRS 16 (24), IAS 16 (18–19)**
  - Initial measurement of the lease liability
  - Lease payments made before the commencement date
  - Less any lease incentives received
  - Any initial direct costs incurred by the lessee
  - Estimate of costs required to dismantle and remove the asset at the end of the lease term to be incurred by the lessee
  - Depreciate asset over its useful life, or the lease term if shorter and no reasonable certainty that lessee will obtain ownership at end of lease – **IFRS 16 (30)**
  - Consider whether IAS 36 impairment procedures are needed – **IFRS 16 (33)**
  - Disclosures:
  - Disclose information about the leases either in a single note or in a separate section of the financial statements – **IFRS 16 (52)**
  - Disclosure is required of the following: – **IFRS 16 (53)**
    - Depreciation charge for the right-of-use assets – **IFRS 16 (53)(a)**
    - Interest expense on lease liabilities – **IFRS 16 (53)(b)**
    - Additions to right-of-use assets – **IFRS 16 (53)(h)**
    - Gains or losses arising from sale and leaseback transactions – **IFRS 16 (53)(i)**
    - Carrying amount of right-of-use assets at the end of the reporting period by class of underlying asset – **IFRS 16 (53)(j)**
    - Details of low value and short-term transactions – **IFRS 16 (53)(c)(d)**

(3) **Sale and leaseback**

- If the fair value of the consideration for the sale of an asset does not equal the fair value, below market terms are accounted for as a prepayment of lease payments and any above market terms are accounted for as additional financing provided by the buyer – **IFRS 16 (101)**
- Any potential adjustment is calculated on the difference between the fair value of the consideration and the fair value of the asset – **IFRS 16 (102)**

(4) **Lessor accounting**

Finance lease:

- A lease that transfers substantially all the risks and rewards incidental to ownership of an underlying asset – **IFRS 16 AppA**
- Recognise a receivable measured at an amount equal to the net investment in the lease – **IFRS 16.67**
- Net investment in the lease is the present value of the payments receivable by the lessor plus the value of any unguaranteed residual value accruing to the lessor – **IFRS 16 AppA**
- Include initial direct costs incurred – **IFRS 16.69**
- Recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment – **IFRS 16.75**
- Finance income should be allocated on a systematic and rational basis – **IFRS 16.76**

Operating lease:

- A lease that does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset – **IFRS 16 AppA**
- The asset should be recorded in the statement of financial position according to its nature – **IFRS 16.71**
- Operating lease income should be recognised on a straight-line basis over the lease term, unless another basis is more appropriate – **IFRS 16.81**
- Asset should be depreciated as per other similar assets – **IFRS 16.84**
- IAS 36 should be applied to determine whether the asset is impaired – **IFRS 16.85**
- Disclosures – **IFRS 16.89**

2 IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*

(1) **Treatment**

- Should only be recognised if reasonable assurance that: – **IAS 20.7**
  - Entity will comply with conditions
  - Grant will be received
- Manner in which received does not affect accounting method adopted – **IAS 20.9**
- Should be recognised as income over periods necessary to match with related costs – **IAS 20.12**
- Income approach, where grant is taken to income over one or more periods should be adopted – **IAS 20.13**
- Grants should not be accounted for on a cash basis – **IAS 20.16**
- Grants in recognition of specific expenses are recognised as income in same period as expense – **IAS 20.17**
- Grants related to depreciable assets usually recognised in proportion to depreciation – **IAS 20.17**
- Grants related to non-depreciable assets requiring fulfilment of certain obligations should be recognised as income over periods which bear the cost of meeting obligations – **IAS 20.18**
- Grant received as compensation for expenses already incurred recognised in period in which receivable – **IAS 20.20**
- Non-monetary grants should be measured at fair value or a nominal amount – **IAS 20.23**

(2) **Presentation of grants related to assets**

- Can be presented in the statement of financial position by: – **IAS 20.24**
  - Setting up the grant as deferred income or
  - Netting it off against the carrying amount of the asset

(3) **Presentation of grants related to income – IAS 20.29**

- Either:
  - Recognised in profit or loss as income separately or under a general heading or
  - Deducted in arriving at the amount of the related expense recognised in profit or loss

(4) **Repayment of government grants**

- Accounted for as a revision to an accounting estimate – **IAS 20.32**

(5) **Government assistance**

- The following forms of government assistance are excluded from the definition of government grants: – **IAS 20.34–35**
  - Assistance which cannot reasonably have a value placed on it
  - Transactions with government which cannot be distinguished from the normal trading transactions of the entity

(6) **Disclosures**

- Required disclosures – **IAS 20.39**

3 IAS 23, *Borrowing Costs*

- Core principle – **IAS 23.1 and 8**
- Qualifying asset – **IAS 23.5 and 7**
- Directly attributable borrowing costs – **IAS 23.10–11**
- Eligible borrowing costs – **IAS 23.12–15**
- Excess of carrying amount over recoverable amount of asset – **IAS 23.16**
- Commencement of capitalisation – **IAS 23.17–19**
- Suspension of capitalisation – **IAS 23.20–21**
- Cessation of capitalisation – **IAS 23.22–25**
- Disclosure – **IAS 23.26**

4 IAS 7, *Statement of Cash Flows*

- Objective of the statement of cash flows
  - The statement of cash flows should show the historical changes in cash and cash equivalents
  - Cash comprises cash on hand and demand deposits – **IAS 7.6**
  - Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value – **IAS 7.6**
- Presentation of a statement of cash flows – **Appendix A**
  - Cash flows should be classified by operating, investing and financing activities – **IAS 7.10**
  - Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity – **IAS 7.13–14**

  - Cash flows from investing activities are those related to the acquisition or disposal of any non- current assets, or trade investments together with returns received in cash from investments (ie, dividends and interest) – **IAS 7.16**
- Financing activities include: – **IAS 7.17**
  - Cash proceeds from issuing shares
  - Cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short- or long-term borrowings
  - Cash repayments of amounts borrowed
  - Dividends paid to shareholders / the non-controlling interest
  - Principal receipts of amounts advanced under leases
  - Cash flows from operating activities
  - There are two methods of presentation allowed:
    - Direct method – **IAS 7.19**
    - Indirect method – **IAS 7.20**

Self-test questions

Answer the following questions

1 Henry

Henry acquired an asset on a lease. The details were as follows.

Date of acquisition	1 January 20X1
Present value of future lease payments	£7,210
Annual lease payments in arrears	£2,000

The interest rate implicit in the lease is 12% p.a. The payments are made on the last day of each year. There is no option to purchase the asset at the end of the lease.

Requirement

In accordance with IFRS 16, *Leases* what is the lease liability at 31 December 20X2? Round your answer to the nearest pound.

2 Sam plc

Sam plc acquired a machine on a lease. The details were as follows.

Date of commencement	1 July 20X6
Present value of future lease payments	£24,300
Deposit (including the first payment)	£8,000
Remaining annual lease payments (in advance)	4 @£8,000
Interest rate implicit in the lease	12%

The useful life of the machine is eight years. There is no option to purchase the machine at the end of the lease.

Requirement

What is the carrying amount of the right-of-use asset as at 30 June 20X7 in accordance with IFRS 16,
Leases?

3 Isaac Co

Isaac Co acquired an item of plant under a lease on 1 January 20X7. The present value of the future lease payments at the commencement date was £7,731,000 and three lease payments of £3 million p.a. are due to be paid in arrears on 31 December each year.

The useful life of the plant is deemed to be six years. There is no option to buy the asset at the end of the lease term.

The interest rate implicit in the lease is 8% p.a.

Requirement

What is the total charge to the statement of profit or loss in respect of this lease for the year ended 31 December 20X7?

4 Alpha plc

Alpha plc enters into a lease with Omega Ltd for a plastics moulding machine.

The terms of the 10 year lease require Alpha plc to make 10 annual lease payments of £36,000 in arrears. The discounted value of the lease payments at the implicit rate within the lease of 6% is £264,960.

There is an option to buy the machine on the final date of the lease for £25,000 (discounted value of £13,950), which Alpha plc is expected to exercise. The useful life of the machine is 15 years.

Requirements

Calculate the following values:

(a) The initial measurement of the right-of-use asset at the commencement of the lease on 1 January 20X1.

(b) The carrying amount of the machine at 31 December 20X1.

(c) The lease liability brought forward at 1 January 20X2.

5 Snow plc

On 1 January 20X1 Snow plc entered into the following lease agreements.

(1) **Snow machine**

To lease a snow machine for five years from Slush plc. The snow machine is estimated to have a useful life of eight years.

Snow plc has agreed to make five annual payments of £35,000, payable in arrears, commencing on 31 December 20X1. The present value of future discounted lease payments is £151,515. There is no option to purchase the machine at the end of the lease. Lease incentives of £3,000 were received by Snow plc in respect of this asset.

The interest rate implicit in the lease is 5%.

(2) **Head office and warehouse**

Snow plc has agreed to sell its Head Office and warehouse to Slush plc on 1 January 20X1 for £6 million. Slush plc is to lease the building back to Snow plc over a period of 10 years.

The carrying amount of the building in Snow plc's books on the date of the sale was £5.2 million, and its fair value was £6 million.

The present value of the lease payments was calculated to be £4.2 million, with the remaining useful life of the building being 15 years.

The transaction constitutes a sale in accordance with IFRS 15.

Requirements

5.1 Calculate the carrying amount of the right-of-use asset at 31 December 20X1 in respect of the snow machine.

5.2 What is the initial measurement of the right-of-use asset in respect of the leased building?

5.3 What is the gain on the sale that should be recognised on 1 January 20X1 in the financial statements of Snow plc?

6 Sidcup plc

On 1 January 20X6, Sidcup plc sold its head office building to Eltham Co for £3 million and immediately leased it back on a 10-year lease. On that date, the carrying value of the building was £2.6 million and its fair value was £3 million. The present value of the lease payments was calculated as £2.1 million. The remaining useful life of the building at 1 January 20X6 was 15 years. The transaction constituted a sale in accordance with IFRS 15.

Requirements

6.1 A right-of-use asset must be recognised in respect of the leased building. At what value should this right-of-use asset be recognised on 1 January 20X6 in the financial statements of Sidcup plc?

6.2 What is the gain on the sale that may be recognised on 1 January 20X6 in the financial statements of Sidcup plc?

7 Noname

The Noname Company decided to carry out a fundamental restructuring of its papermaking division which operates in Hyberia. The effect was that most activities carried out in this location would cease with a number of employees being made redundant, whereas other activities and employees would relocate to Sidonia where there was unused capacity. Negotiations with landlords and employee representatives were concluded on 30 December 20X7 and a formal announcement was made to all employees on 31 December 20X7.

The restructuring budget approved by the board of directors in November 20X7 included the following amounts:

	£
Payments to employees:	
Termination payments to those taking voluntary redundancy	90,000
Termination payments to those being made compulsorily redundant	180,000
One-off payments to employees agreeing to move to Sidonia	37,000
Employment cost for closing down activities in Hyberia in preparation for the move to Sidonia	50,000
Lease costs:	
5 years remaining of a lease which can immediately be sublet for £70,000 per annum	45,000 per annum
7 years remaining of a lease which can immediately be sublet for £35,000 per annum	90,000 per annum
Cost of moving plant and equipment from Hyberia to Sidonia26,000 Impairment losses on non-current assets under IAS 36, *Impairment of Assets*	110,000
Trading transactions in Hyberia up to date of closure, other than those itemised above:	
Revenue	850,000
Expenses	1,150,000

None of these amounts has yet been recognised in Noname's financial statements. The effect of the time value of money is immaterial.

Requirement

Determine the amounts to be included in the financial statements for the Noname Company for the year ending 31 December 20X7 according to IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

8 Tonto

The following information relates to the draft financial statements of Tonto.

Summarised statements of financial position as at:

31 March 20X1 31 March 20X0

	£'000	**£'000**	**£'000**	**£'000**
ASSETS				
Non-current assets				
Property, plant and equipment (Note (1))		19,000		25,500
Current assets				
Inventory		12,500		4,600
Trade receivables		4,500		2,000
Tax refund due		500		nil
Bank		nil		1,500
Total assets		36,500		33,600
EQUITY AND LIABILITIES				
Equity				
Equity shares of £1 each (Note (2))		10,000		8,000
Share premium (Note (2))	3,200		4,000	
Retained earnings	4,500	7,700	6,300	10,300
		17,700		18,300
Non-current liabilities				
10% loan note (Note (3))	nil		5,000	
Lease obligations	4,800		2,000	
Deferred tax	1,200	6,000	800	7,800
Current liabilities				
10% loan note (Note (3))	5,000		nil	
Tax	nil		2,500	
Bank overdraft	1,400		nil	
Lease obligations	1,700		800	
Trade payables	4,700	12,800	4,200	7,500
Total equity and liabilities		36,500		33,600

CHAPTER 14

Summarised statements of profit or loss for the years ended:

	31 March 20X1	31 March 20X0
	£'000	£'000
Revenue	55,000	40,000
Cost of sales	(43,800)	(25,000)
Gross profit	11,200	15,000
Operating expenses	(12,000)	(6,000)
Finance costs (Note (4))	(1,000)	(600)
Profit (loss) before tax	(1,800)	8,400

	31 March 20X1	31 March 20X0
	£'000	£'000
Income tax relief (expense)	700	(2,800)
Profit (loss) for the year	(1,100)	5,600

The following additional information is available:

(1) Property, plant and equipment is made up of:

As at:	31 March 20X1	31 March 20X0
	£'000	£'000
Leasehold property	nil	8,800
Owned plant	12,500	14,200
Leased plant	6,500	
	19,000	25,500

During the year Tonto sold its leasehold property for £8.5 million and entered into an arrangement to rent it back from the purchaser. There were no additions to or disposals of owned plant during the year. The depreciation charges (to cost of sales) for the year ended 31 March 20X1 were:

	£'000
Leasehold property	200
Owned plant	1,700
Leased plant	1,800
	3,700

(2) On 1 July 20X0 there was a bonus issue of shares from share premium of one new share for every 10 held. On 1 October 20X0 there was a fully subscribed cash issue of shares at par.

(3) The 10% loan note is due for repayment on 30 June 20X1. Tonto is in negotiations with the loan provider to refinance the same amount for another five years.

(4) The finance costs are made up of:

For year ended:	**31 March 20X1**	**31 March 20X0**
	£'000	**£'000**
Lease charges	300	100
Overdraft interest	200	nil
Loan note interest	500	500
	1,000	600

Requirement

Prepare a statement of cash flows for Tonto for the year ended 31 March 20X1 in accordance with IAS 7, *Statement of Cash Flows*, using the indirect method.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

The lease is for eight months, which counts as a short-term lease, and so it does not need to be recognised in the statement of financial position. If the short-term lease exemption is adopted, then the amount charged to profit or loss for the year ended 30 June 20X6 is £32,000 × 2/8 = £8,000.

If the short-term lease exemption is not adopted, then the standard IFRS 16 model must be applied; an asset and liability will be recognised for the leased asset at 30 June 20X6.

Answer to Interactive question 2

Question	Fill in your answer
A company leases a laptop computer for their financial controller over a three-year period.	This can be classified as a lease, or the company may make an election for this lease to be classified as a low value item, and therefore exempt from the IFRS 16 standard model.
A company leases a photocopier. The copier will remain on the client site, and will only be returned to the lessor in the event of a major repair.	Lease: The arrangement involves an identified asset which the customer has the right to control. Substitution rights are not substantive.
A company leases cars for their team of sales representatives for a three-year period. The cars are required to be estate models, but from time to time, the car may be changed by the lessor.	Not a lease: The lease is not for identified assets, as the lessor can change the exact model of car provided during the lease.
A company acquires three architect's drawing desks which are paid for over 10 months. The company already has four of these desks, and no elections have been made.	These would qualify as a short-term lease, however, IFRS 16 requires the election to be made for the whole class of assets, and this has not been done, so the full standard should be applied.

Answer to Interactive question 3

3.1 Total lease liability at 31 December 20X1 = £ **17,356**

Capital > 1 year = £ **9,092**

< 1 year (β) = £ 8,264

3.2 Journals

		£	£
DEBIT	Right-of-use asset	24,869	
CREDIT	Lease liability		24,869
	Being recognition of right-of-use asset and lease liability at commencement of lease.		
DEBIT	Finance charge (profit or loss)	2,487	
CREDIT	Lease liability		2,487
	Being interest on lease		

		£	£
DEBIT	Lease liability	10,000	
CREDIT	Cash		10,000
	Being payment in respect of lease		

Answer to Interactive question 4

At the end of year 1 the liability will be measured as:

	£
Opening balance	177,297
Interest 5%	8,865
	186,162
Current liability	50,000
Non-current liability (bal. fig).	136,162
	186,162

Answer to Interactive question 5

Calculations

(1) **Calculation of the right-of-use asset**

	£
PVFLP	11,164
Deposit	575
	11,739

Depreciate the asset over seven years

11,739/7 = £1,677 per annum

Carrying amount at 31 December 20X1: £11,739 – £1,677 = £10,062

Carrying amount at 31 December 20X2: £10,062 – £1,677 = £8,385

(2) **Calculation of the lease liability**

Balance of the lease liability at 31 December 20X1: £9,834

Balance of the lease liability at 31 December 20X2: £8,424

CHAPTER 14

	Cr	Cr	Dr	Cr
	Bal b/f 1 Jan	Interest accrued at 6%	Payment 31 Dec	Bal c/f 31 Dec
	£	£	£	£
20X1	11,164	670	(2,000)	9,834
20X2	9,834	590	(2,000)	8,424

Note: You can do these calculations in vertical format (as in the chapter body) or horizontal, whichever is easiest. The principles are the same.

Answer to Interactive question 6

Journal entries at date of disposal

		£	£
DEBIT	Cash	120,000	
CREDIT	Non-current asset (carrying amount)		70,000
CREDIT	Gain on rights transferred (W2)		4,906
DEBIT	Right-of-use asset (W1)	63,131	
CREDIT	Lease liability (PVFLP)		108,225

WORKINGS

(1) **Calculate the right-of-use asset**

Carrying amount × (PVFLP ÷ FV) = £70,000 × (£108,225 ÷ £120,000) = £63,131

(2) **Calculate the gain on rights transferred**

As follows:

a. Calculate the gain on the sale:

Fair value – carrying amount = £120,000–£70,000 = £50,000

b. Calculate the gain relating to the rights retained by the seller/lessee:

Gain × PVFLP/fair value = £50,000 × £108,225/£120,000 = £45,094

c. Calculate the gain relating to the rights transferred:

Total gain (1) – Gain relating to the rights retained (2) = £50,000 – £45,094 = £4,906

(3) **Lease liability and interest accrued**

		£
1.1.X1	Lease liability (PVFLP)	108,225
31.12.X1	Interest accrued 108,225 × 5%	5,411
31.12.X1	Instalment paid	(25,000)
Lease liability carried down at 31.12.X1		88,636
31.12.X2	Interest accrued 88,636 × 5%	4,432
31.12.X2	Instalment paid	(25,000)
Lease liability carried down at 31.12.X2		68,068

Therefore, current liabilities (<12 months) at 31.12.X1 would be £88,636 – £68,068 = £20,568, of which £4,432 is the finance charge (interest payable).

Alternative presentation:

	Balance	Finance cost at 5%	Lease payment	Balance
	£	£	£	£
20X1	108,225	5,411	(25,000)	88,636
20X2	88,636	4,432	(25,000)	68,068

Statement of profit or loss

	£
Depreciation (63,131/4)	(15,783)
Interest (108,225 × 5%) (W3)	(5,411)

Statement of financial position

	£
Non-current assets	
Carrying amount at 1 January 20X1 (W1)	63,131
Depreciation (W3)	(15,783)
Carrying amount at 31 December 20X1	47,348
Non-current liabilities	
Obligations under leases (W3)	68,068
Current liabilities	
Obligations under leases (88,636 – 68,068)	20,568

Answer to Interactive question 7

The answer is £12,973

Stage 1: Gain on sale: £740,000 – £500,000 = £240,000

Stage 2: Gain relating to rights retained = £(240,000 × 700,000/740,000) = £227,027 Stage 3:

Gain relating to rights transferred = £240,000 – £227,027 = £12,973

Answer to Interactive question 8

IAS 20 gives the following arguments in support of each method.

Capital approach

(1) The grants are a **financing device**, so should go through the statement of financial position. In the statement of profit or loss and other comprehensive income they would simply offset the expenses which they are financing. No repayment is expected by the Government, so the grants should be credited directly to shareholders' interests.

(2) Grants are **not earned**, they are incentives without related costs, so it would be wrong to record them in profit or loss.

Income approach

(1) The grants are **not received from shareholders** so should not be credited directly to shareholders' interests.

(2) Grants are **not given or received for nothing**. They are earned by compliance with conditions and by meeting obligations. There are therefore associated costs with which the grant can be matched in the statement of profit or loss and other comprehensive income, as these costs are being compensated by the grant.

(3) Grants are an extension of **fiscal policies** and so, as income and other taxes are charged against income, grants should be credited to income.

Answer to Interactive question 9

Cost of each asset as at 31 December 20X8

	Asset X	Asset Y
Borrowing costs	**£'000**	**£'000**
£5.0m/£10m × 10%	500	1,000
Less investment income		
To 30 June 20X8: £2.5m/£5.0m × 8% × 6/12	(100)	(200)
	400	800
Cost of assets		
Expenditure incurred	5,000	10,000
Borrowing costs	400	800
	5,400	10,800

Answer to Interactive question 10

Capitalisation rate = weighted average rate = (10% × (120 ÷ (120 + 80))) + (9.5% × (80 ÷ (120 +80))) = 9.8%

Borrowing costs = (£30m × 9.8%) + (£20m × 9.8% × 3/12) = £3.43m

Answer to Interactive question 11

Elida – statement of cash flows for the year to 31 March 20X8

	£'000	£'000
Cash flows from operating activities		
Profit before tax		440
Loss on sale of plant		90
Depreciation		280
Early redemption penalty		20
Finance costs		50
Investment income		(60)
Increase in warranty provision (200 – 100)		100
		920
Increase in inventory (1,210 – 810)		(400)
Decrease in receivables (480 – 540)		60
Increase in trade payables (1,410 – 1,050)		360
Cash generated from operations		940
Interest paid		(50)

	£'000	£'000
Tax refund received (W1)		60
Net cash from operating activities Cash flows from investing activities		950
Proceeds of sale of plant (240 – 90)	150	
Purchase of plant (W2)	(1,440)	
Income from investment property (60 – 20)	40	
Net cash used in investing activities Cash flows from financing activities		(1,250)
Share issue ((1,000 – 600) + 600)	1,000	
Loan notes repaid	(400)	
Early redemption penalty	(20)	
Dividend paid (1,000 × 5 × 0.03)	(150)	
Net cash from financing activities		430
Net increase in cash and cash equivalents		130
Cash and cash equivalents at beginning of period		(120)
Cash and cash equivalents at end of period		10

WORKINGS

(1) **Income tax payable**

	£'000		£'000
Bal b/d (current tax)	50	Bal b/d (deferred tax)	30
Bal c/d (current tax)	150	Profit or loss charge	160
Bal c/d (current tax)	50	Cash received (balancing figure)	60
	250		250

(2) **Property, plant and equipment**

	£'000		£'000
Bal b/d	1,860	Disposal	240
Revaluation (150 – 50)	100	Depreciation	280
Additions (balancing figure)	1,440	Bal c/d	2,880
	3,400		3,400

Answers to Self-test questions

1 Henry

Liability at 31.12.X2 is £4,804

Date	B/f	Interest 12%	Payment	C/f
	£	£	£	£
31.12.X1	7,210	865	(2,000)	6,075
31.12.X2	6,075	729	(2,000)	4,804

2 Sam plc

The carrying amount of the machine is 32,300 – 6,460 = £25,840

	£
Lease liability (PVFLP)	24,300
Deposit payments at the start of the lease (deposit)	8,000
Right-of-use asset	32,300

Depreciate the machine over the shorter of the lease term (5 years) and the useful life (8 years)

Depreciation charge for the year £32,300/5 = £6,460

3 Isaac Co

Total lease liability

	£	Finance charge
Initial liability (PV of future lease payments)	7,731,000	
Interest 8% (£7,731,000 × 8%)	618,480	618,480
Payment	(3,000,000)	
Total lease liability at 31.12.X8	5,349,480	

Depreciation is charged based on the shorter of the lease term (three years) and the useful life (six years) as there is no option to purchase the asset the end of the lease period.

		Depreciation charge
Right-of-use asset	7,731,000	
Depreciation charge 7,731,000/3	(2,577,000)	2,577,000
Carrying amount	5,154,000	

Charge to the profit and loss is £618,480 + £2,577,000 = £3,195,480

4 Alpha plc

(a) **Right-of-use asset**

	£
Discounted future lease payments	264,960
Option to purchase (discounted)	13,950
Lease liability and right-of-use asset	278,910

(b) **Carrying amount at 31 December 20X1**

	£
Right-of-use asset	278,910
Less Depreciation (W1)	(18,594)
Carrying amount	260,316

WORKING

278,910/15 years = £18,594

The asset is depreciated over 15 years as there is an option to purchase the asset which Alpha plc is expected to exercise.

(c) **Lease liability brought forward at 1 January 20X2**

	£
Lease liability	278,910
Interest at 6%	16,735
Less payment	(36,000)
Liability	259,645

5 Snow plc

5.1 **Right-of-use asset at 31 December 20X1**

Lease liability

	B/f	Interest @ 5%	Payment	C/f
	£	£	£	£
31 December 20X1	151,515	7,576	(35,000)	124,091

	£
Right-of-use asset	
Present value of future lease payments	151,515
Less lease incentive	(3,000)
Right-of-use asset	148,515
Less depreciation 148,515/5 years	(29,703)
Carrying amount 31 December	118,812

5.2 Calculation of the right-of-use asset

Building

Calculation of the right-of-use asset:

Carrying amount × (present value of lease payments ÷ fair value of asset)

£5.2m × (£4.2m ÷ £6m) = £3.64m

5.3 **Stage 1:** Gain on sale: £6m – £5.2m = £0.8m

Stage 2: Gain that relates to rights retained = £0.8m × (£4.2m ÷ £6m) = £0.56m

Stage 3: Gain relating to rights transferred = £0.8m – £0.56m = £0.24m

6 Sidcup plc

6.1 £1,820,000

IFRS 16 requires that, at the start of the lease, Sidcup should measure the right-of-use asset arising from the leaseback of the building at the proportion of the previous carrying amount of the building that relates to the right of use retained. This is calculated as carrying amount × discounted lease payments/fair value. The discounted lease payments were given in the question as £2.1 million.

The right-of-use asset is therefore: £2.6m × £2.1m/£3m = £1,820,000.

6.2 £120,000

Sidcup only recognises the amount of gain that relates to the rights transferred.

Stage 1: Gain is £3,000,000 – £2,600,000 = £400,000

Stage 2: Gain relating to rights retained £(400,000 × 2,100,000/3,000,000) = £280,000

Stage 3: Gain relating to rights transferred £(400,000 – 280,000) = £120,000

7 Noname

The total amount recognised in profit or loss under IAS 37 is the £270,000 restructuring provision + the £110,000 impairment losses = £380,000.

The five-year lease is not onerous because the premises can be sublet at profit. The seven-year lease is onerous and under IFRS 16 will lead to an impairment review of the right-of-use asset for the premises; however following IFRS 16 there is no longer a provision to be recognised under IAS 37.

Under IAS 37.80 all the payments to employees should be included in the restructuring provision, with the exception of the employment costs of £50,000 in preparation for the move to Sidonia and £37,000 payable to those moving to Sidonia – this relates to the ongoing activities of the business, so is disallowed by IAS 37.80(b). For the same reason the costs of moving plant and equipment is disallowed. Impairment losses reduce the carrying amount of the relevant assets rather than increasing the restructuring provision and revenue less expenses are trading losses which are disallowed by IAS 37.63. So provision = £270,000.

8 Tonto

Tonto statement of cash flows for the year ended 31.3.20X1

	£'000	£'000
Cash flows from operating activities		
Loss before tax	(1,800)	
Depreciation (W1)	3,700	
Interest expense	1,000	
Loss on disposal of leasehold property (8,500 – (8,800 – 200))	100	
Increase in inventories (12,500 – 4,600)	(7,900)	
Increase in receivables (4,500 – 2,000)	(2,500)	

	£'000	£'000
Increase in payables (4,700 – 4,200)	500	
Cash used in operations	(6,900)	
Interest paid	(1,000)	
Tax paid (W2)	(1,900)	
Net cash used in operating activities		(9,800)
Cash flows from investing activities		
Cash from sale of leasehold property	8,500	
Net cash from investing activities Cash flows from financing activities		8,500
Dividends paid (6,300 – 4,500 – 1,100)	(700)	
Payments made under leases (W3)	(2,100)	
Share issue (10,000 + 3,200) – (8,000 + 4,000)	1,200	
Net cash used in financing activities		(1,600)
Net decrease in cash and cash equivalents		(2,900)
Cash and cash equivalents at 31.3.20X0		1,500
Cash and cash equivalents at 31.3.20X1		(1,400)

WORKINGS

(1) **PPE – CARRYING AMOUNT**

	£'000		£'000
B/d	25,500	Disposal (8,800 – 200)	8,600
Lease plant additions		Depreciation (β)	3,700
(6,500 – 2,500 + 1,800)	5,800	C/d	19,000
	31,300		31,300

(2) **INCOME TAX**

	£'000		£'000
Profit or loss	700	31.3.X0 – Current tax	2,500
31.3.X1 – Deferred tax	1,200	31.3.X0 – Deferred tax	800
Tax paid β	1,900	Refund due	500
	3,800		3,800

(3) **LEASE LIABILITY**

	£'000		£'000
Payments made β	2,100	Balance b/f (2,000 + 800)	2,800
		Additions (W1)	5,800
Balance c/f (4,800 + 1,700)	6,500		
	8,600		8,600

Chapter 15

Financial instruments: presentation and disclosure

Introduction

Learning outcomes

Chapter study guidance

Learning topics

1 Overview of material from earlier studies

2 Objective and scope

3 Disclosures in financial statements

4 Other disclosures

5 Financial instruments risk disclosure

Summary

Further question practice

Technical reference

Self-test questions

Answers to Interactive questions

Answers to Self-test questions

Introduction

Learning outcomes

- Identify and explain current and emerging issues in corporate reporting
- Determine and calculate how different bases for recognising, measuring and classifying financial assets and financial liabilities can impact upon reported performance and position
- Explain and appraise accounting standards that relate to an entity's financing activities which include: financial instruments; leasing; cash flows; borrowing costs; and government grants

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
1	**Overview of material from earlier studies** The use of financial instruments by business for funding, investment and risk management purposes is an essential part of operations. You will need to prepare detailed disclosures for financial instruments and establish the correct presentation of preference shares and convertible instruments between debt and equity.	**Approach** Although you will have a detailed knowledge of IAS 32 from earlier studies, the importance of this topic cannot be overestimated. Make sure you understand the issues relating to the accounting of compound financial instruments. **Stop and think** When might a contract require delivery of the entity's own equity instruments but be classified as a financial liability?	At Advanced Level, you will be concerned with more complex issues than at Professional Level, for example the sometimes difficult distinction between debt and equity. An ethical dilemma may arise whereby a company wishes to reduce gearing by claiming that an instrument is equity rather than a liability.	**IQ7: Purchase of own equity instruments** This question has the finance director of a company claiming that an instrument is equity rather than a liability, and you have to discuss whether they are correct.
2	**Objective and scope** This is a short section on the objective and scope	**Approach** The key point to remember from this short section is that the objective of IFRS	An exam question would not ask for a list of instruments that IFRS 7 does not apply to. However,	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
	of the standard that will take up the rest of the chapter: IFRS 7, *Financial Instruments: Disclosures*	7 is for the user to evaluate: • the **significance** of financial instruments for the entity's **financial position and performance**; and • the **nature and extent of risks** arising from financial instruments. **Stop and think** IFRS 7 applies to recognised and unrecognised financial instruments.	you would be expected to know that disclosures relating to certain instruments are covered by other standards, for example IFRS 2, *Share-based payment*.	
3	**Disclosures in financial statements** The detailed qualitative and quantitative disclosures required by IFRS 7 are intended to provide to the users of financial statements an understanding of the significance of financial instruments for the entity's position and performance, and an analysis of the risks to which the entity is exposed and how it manages them.	**Approach** There is no short cut to reading through and understanding these disclosures. Rather than learn them by heart, it is best to know where to find them in the open books. **Stop and think** The individual classes of financial instruments will mean more to you once you have studied recognition and measurement in Chapter 16.	As part of an audit question you may need to mention procedures to check whether financial instruments have been disclosed in the financial statements in accordance with IFRS 7.	N/A
4	**Other disclosures** This section contains summaries of and references to quantitative and qualitative	**Approach** Skim through **Stop and think** IFRS 13, *Fair Value Measurement* affects	This section will not be examined specifically; it is for awareness only to link to other material.	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
	disclosures in the financial statements which are covered elsewhere.	a large number of areas, particularly financial instruments.		
5	**Financial instruments risk disclosure** IFRS 7 also provides an analysis of the risks to which the entity is exposed and how it manages them.	**Approach** Study the table in Section 5.1. You should focus on credit risk, liquidity risk and market risk. **Stop and think** What qualitative disclosures are required by IFRS 7 in relation to risk?	Risk disclosures are likely to be examined in the context of audit risks and procedures.	N/A However, you can try Self-test questions 2 and 3, which deal with risk and sensitivity analysis.

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Overview of material from earlier studies

Section overview

- IAS 32 applies to all entities and all types of financial instruments except where explicitly covered by another standard, such as IFRS 10 for subsidiaries and IAS 28 for associates and joint ventures.
- A financial instrument should be classified as either equity, financial liability or financial asset. This classification is made at the time the financial instrument is issued and not changed subsequently.
- Compound financial instruments, ie, instruments that contain both a liability and an equity component, should be split into their component parts at the date they are issued.
- Interest, dividends, losses and gains arising from financial instruments classified as financial liabilities are recognised in the profit or loss for the year. Dividends paid to holders of a financial instrument classified as equity are charged directly against equity.
- Financial assets and financial liabilities are presented as separate items in the statement of financial position with offset being allowed only in limited cases.
- Treasury shares are deducted from equity with the consideration paid or received recognised directly in equity. Gains or losses on the purchase, sale, issue or cancellation of equity instruments are not recognised in profit or loss.

1.1 Refresh your memory

The definition of a financial instrument is consistent throughout the accounting standards covering financial instruments. It is introduced in IAS 32.

Definition

Financial instrument: Any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

Note that a financial instrument has **two parties**. It should be recognised as an **asset** by one party and either a **liability or equity** by the other. The classification of a financial instrument as a financial liability or equity is particularly important as it will have an effect on gearing.

1.2 Test your memory

Try these questions to see how well you remember the material covered in your earlier studies.

Interactive question 1: Financial instruments

Why do you think that physical assets and prepaid expenses do not qualify as financial instruments?

See **Answer** at the end of this chapter.

Interactive question 2: Liability or equity?

During the financial year ended 31 December 20X5, Kim issued the financial instrument described below. Identify whether it should be classified as liability or equity, giving reasons for your choice.

Redeemable preference shares with a coupon rate 5%. The shares are redeemable on 31 December 20X9 at premium of 20%.

See **Answer** at the end of this chapter.

Interactive question 3: Convertible bond 1

An entity issues a convertible bond for £1,000. The bond is convertible into equity shares of the issuer at the discretion of the holder at any time in the next 10 years. The bond converts into a variable number of shares equal to the value of the liability.

The entity also issues £7,000 of 8% convertible redeemable preference shares. In five years' time the preference shares will either be redeemed or converted into 5,000 equity shares of the issuer, at the option of either the holder or issuer.

Requirement

How should the entity account for the instruments according to IAS 32?

See **Answer** at the end of this chapter.

Interactive question 4: Convertible bond 2

An entity issued 5,000 8% convertible bonds at par value of £10 on 1 January 20X5. Each bond is convertible into three ordinary shares on 31 December 20X6. Interest is payable annually in arrears. The entity incurred transaction costs of £1,000. On the date of issue the market interest rate for similar debt without the conversion option was 10%.

Requirement

Calculate the liability and equity component of the convertible bond on issue. See **Answer** at the end of this chapter.

Interactive question 5: Options contract

An entity enters into an options contract to acquire 100 ounces of platinum in 90 days' time. The entity will settle the contract by delivering as many of its own shares as are equal to the cash value of
£1,000 on the purchase date.

Requirement

Explain whether the options contract should be classified as a financial asset, financial liability or equity.

See **Answer** at the end of this chapter.

Interactive question 6: Offsetting

An entity issues debt with a variable rate of interest linked to SONIA. SONIA (Sterling Overnight Index Average) is a benchmark rate that replaced LIBOR in 2021. It enters into a corresponding, receive floating, pay fixed interest rate swap for the period of the debt. The effect of the two instruments is to synthesise a fixed-rate long-term loan.

Requirement

Explain whether the two instruments should be presented separately or whether they should be offset.

See **Answer** at the end of this chapter.

Professional skills focus: Assimilating and using information

This section was for revision from earlier studies. At Advanced Level, the scenarios will be much more complex and you will need to sift through detail and pick out the important principles that you need to apply. So if you're at all shaky on the above examples, it is a good idea to practise questions on this area from your earlier studies.

1.3 More complex issues

1.3.1 Debt/equity distinction

The separation of debt and equity components of a financial instrument should be familiar to you from your Professional Level studies, and you should not have had any serious difficulty with the convertible bond question above. However, at Advanced Level you will need to consider more complex, 'real world' issues. In practice, the debt/equity distinction may not be clear cut. Classification of financial instruments as debt or equity can have a significant effect on the financial statements. Guidance is provided in IAS 32, *Financial Instruments: Presentation* (and other standards for items outside IAS 32's scope), but there are sometimes areas where it is difficult to determine whether a transaction is debt or equity.

A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. It is necessary to consider whether the settlement results in receipt or delivery of variable or fixed number of the entity's own equity instruments.

If the contract results in delivery of variable number of equity instruments, the fair value of the equity instruments equals to the amount of the fixed contractual right or obligation. Such a contract does not evidence a residual interest in the entity's assets after deducting all of its liabilities.

The following contracts require delivery of the entity's own equity instruments but are **classified as financial liability**:

- A contract to deliver as many of the entity's own equity instruments as are equal in value to £6,000
- A contract to deliver as many of the entity's own equity instruments as are equal in value to 200 ounces of gold

Contingent settlement provisions

A financial instrument may require the entity to deliver cash or another financial asset in the event of **occurrence or non-occurrence of uncertain future events** that are beyond the control of both the issuer and holder of the instrument. These are known **as contingent settlement provisions** and could relate to changes in stock market index, consumer price index, interest rate, issuer's future profits or revenues. Such instruments are classified as financial liability. This is because the issuer **does not have an unconditional right to avoid** delivering cash or another financial asset.

The financial instrument would be an equity instrument if it has equity-like features, for example, obligation arises only in the event of liquidation of the issuer.

Context example: Redemption of preference shares

High Growth Bank issues 7% fixed preference shares. The dividends on the preference shares are cumulative. The terms and conditions of the issue of preference shares indicate that they will be redeemed if the net profit of the bank increases by more than 50% in the next three years.

In this case, the contingent event is outside the control of both the bank and the holder. If the net profit of the bank increases by more than 50% in the next three years, it does not have the unconditional right to avoid delivering cash. The preference shares also pay a fixed cumulative dividend and hence are classified as financial liability.

Context example: Contingent convertible bonds (CoCos)

Contingent convertible bonds issued by Stable Bank give it the right to convert the debt to equity in the event of its capital ratio falling below a pre-set level. To offset the risk the holder is undertaking, the yields that Stable Bank offers on its CoCos are 6.6% compared to an average yield to maturity on other medium-term bonds of 3.5%.

Stable Bank must classify the bonds as a hybrid instrument with both debt and equity features.

1.3.2 Practical implications

The classification of financial instruments as debt versus equity is particularly important with items that are financial liabilities or equity as the presentation of the two items and associated financial effects are very different.

Consider the following examples.

Worked example: Debt or equity?

1 Acquittie issued 40 million non-redeemable £1 preference shares at par value. Under the terms attaching to the preference shares, a dividend is payable on the preference shares only if Acquittie also pays a dividend on its ordinary shares relating to the same period.

2 Acquittie entered into a contract with a supplier to buy a significant item of equipment. Under the terms of the agreement the supplier will receive ordinary shares with an equivalent value of £5 million one year after the equipment is delivered.

3 The directors of Acquittie, on becoming directors, are required to invest a fixed agreed sum of money in a special class of £1 ordinary shares that only directors hold. Dividend payments on the shares are discretionary and are ratified at the annual general meeting (AGM) of the company. When a director's service contract expires, Acquittie is required to repurchase the shares at their nominal value.

Solution

1 IAS 32 requires a financial instrument to be classified as a liability if there is **a contractual obligation** to deliver cash or another financial asset to another entity.

In the case of the preference shares, as they are **non-redeemable**, there is **no obligation to repay the principal**.

In the case of the **dividends**, because of the condition that preference dividends will only be paid if ordinary dividends are paid in relation to the same period, the **preference shareholder has no contractual right** to a dividend. Instead, the distributions to holders of the preference shares are at the discretion of the issuer as **Acquittie can choose** whether or not to pay an ordinary dividend and therefore a preference dividend. Therefore, there is **no contractual obligation** in relation to the dividend.

As there is no contractual obligation in relation to either the dividends or principal, the **definition of a financial liability has not been met** and the preference shares should be treated as **equity** and initially recorded at **fair value** ie, their par value of £40 million.

The treatment of **dividends** should be consistent with the classification of the shares and should therefore be charged directly to **retained earnings**.

2 The price of the equipment is fixed at £5 million one year after delivery. In terms of recognition and measurement of the equipment, the £5 million price would be discounted back one year to its present value.

The company is paying for the equipment by issuing shares. However, this is **outside the scope of IFRS 2**, *Share-based Payment* because the payment is not dependent on the value of the shares, it is fixed at £5 million.

This is an example of a contract that "will or may be settled in an entity's own equity instruments and is a non-derivative for which the entity is or may be obliged to deliver a **variable** number of the entity's own equity instruments" (IAS 32.11) ie, a financial liability.

It is the number of shares rather than the amount paid that will vary, depending on share price. Therefore it should be classed as a **financial liability** and initially measured at the **present value** of the £5 million.

Subsequently, as it is not measured at fair value through profit or loss (as it is not held for short- term profit-taking or a derivative), it should be measured at **amortised cost**.

As a result, **interest** will be applied to the discounted amount over the period until payment and recognised in **profit or loss** with a corresponding increase in the financial liability.

3 Most ordinary shares are treated as equity as they do not contain a contractual obligation to deliver cash.

However, in the case of the directors' shares, a **contractual obligation to deliver cash exists** on a specific date as the shares are **redeemable** at the end of the service contract.

The redemption is **not discretionary**, and Acquittie has no right to avoid it. The mandatory nature of the repayment makes this capital a financial liability. The financial liability will initially be recognised at its fair value ie, the present value of the payment at the end of the service contract. It will be subsequently measured at amortised cost and effective interest will be applied over the period of the service contract.

Dividend payments on the shares are **discretionary** as they must be ratified at the AGM. Therefore, no liability should be recognised for any dividend until it is ratified. When recognised, the classification of the **dividend** should be consistent with the classification of the shares and therefore any dividends are classified as a **finance cost** rather than as a deduction from retained earnings.

Professional skills focus: Applying judgement

The classification of a financial instrument as debt or equity is an area where judgement must be applied. This area is still under consideration by the IASB in the form of a Discussion Paper.

Professional skills focus: Structuring problems and solutions

The debt/equity distinction also exercises the student/practitioner's ability to structure problems and approach them logically. For example, just because it may result in the receipt or delivery of the entity's own equity instruments does not necessarily follow it is an equity instrument.

Interactive question 7: Purchase of own equity instruments

Emporium is a listed retail group, and has a year end of 31 October. On 21 October 20X8, Emporium carried out a bonus issue where the shareholders of Emporium received certain rights. The shareholders are able to choose between the following:

- receiving newly issued shares of Emporium, which could be traded on 30 November 20X8; or
- transferring their rights back to Emporium by 10 November 20X8 for a fixed cash price which would be paid on 20 November 20X8.

While preparing the financial statements at 31 October 20X8, the finance director of Emporium argued that the criteria for the recognition of a financial liability as regards the second option were not met at 31 October 20X8 because it was impossible to reliably determine the full amount to be paid until 10 November 20X8.

Requirement

Discuss whether the finance director is correct regarding the recognition of a financial liability.

See **Answer** at the end of this chapter.

2 Objective and scope

Section overview

This section discusses the objectives and sets out the scope of IFRS 7, *Financial Instruments: Disclosures*.

2.1 Objective

The principles of IFRS 7 complement the principles for recognising, measuring and presenting financial assets and financial liabilities in IAS 32, *Financial Instruments: Presentation* and IFRS 9, *Financial Instruments*.

IFRS 7 requires entities to provide **disclosures** in their financial statements that enable users to **evaluate**:

- the **significance** of financial instruments for the entity's **financial position and performance**; and
- the **nature and extent of risks** arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks.

The main presentation and disclosure requirements as detailed in IFRS 7 and IAS 32 together with certain aspects of recognition and measurement of IFRS 9 have already been covered at Professional Level. This chapter extends the coverage of the disclosure requirements of IFRS 7 and the presentation requirements.

2.2 Scope

IFRS 7 applies to all entities and to **all types** of financial instruments**, except instruments that are specifically covered by other standards**. Examples of financial instruments not covered by IFRS 7 include the following:

- Interests in subsidiaries, associates and joint ventures that are accounted for in accordance with IFRS 10, *Consolidated Financial Statements* or IAS 28, *Investments in Associates and Joint Ventures*
- Employers' rights and obligations arising from employee benefit plans, to which IAS 19, *Employee Benefits* applies
- Insurance contracts as defined in IFRS 4, *Insurance Contracts*
- Financial instruments, contracts and obligations under share-based payment transactions to which IFRS 2, *Share-based Payment* applies

IFRS 7 applies to recognised and unrecognised financial instruments. Recognised financial instruments include financial assets and financial liabilities that are within the scope of IFRS 9. Unrecognised financial instruments include some financial instruments that, although outside the scope of IFRS 9, are within the scope of IFRS 7 (such as some loan commitments).

IFRS 7 also applies to contracts to buy or sell a non-financial item that are within the scope of IFRS 9 because they can be settled net and there is not the expectation of delivery, receipt or use in the ordinary course of business.

2.3 General considerations

2.3.1 Classes of financial instruments and level of disclosures

IFRS 7 requires that certain disclosures should be given by class of financial instruments. The classes of financial instruments that will be disclosed should be appropriate to the nature of the information disclosed and should take into account the characteristics of those financial instruments. An entity should provide sufficient information to permit reconciliation to the line items presented in the statement of financial position.

In deciding how to disclose the classes of financial instruments, an entity should not necessarily adopt the classification of IFRS 9. The classes should be determined by the entity, but at the minimum it should:

- provide distinctive classes for financial instruments at amortised cost and financial instruments at fair value; and
- provide a separate class or classes for financial instruments outside the scope of IFRS 7.

Note: A 'class' is not the same as a classification under IFRS 9 (investment in equity instruments, financial assets held at amortised cost, financial assets at fair value through profit or loss and financial assets at fair value through other comprehensive income).

2.3.2 Significance of financial instruments for financial position and performance

An entity must disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance.

2.3.3 Risks from financial instruments

IFRS 7 requires qualitative and quantitative disclosure about the following risks associated with financial instruments:

- **Market risk**. This is the risk of changes in the market value of a financial instrument. When changes in the market value can be attributed to changes in interest rates then the market risk is normally called interest rate risk, and when it can be attributed to changes in exchange rates, market risk is called currency risk.
- **Credit risk**. This is the risk that one party to a financial instrument will fail to fulfil the obligations that arise for the financial instrument causing loss to the other party.
- **Liquidity risk**. This is the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities.

3 Disclosures in financial statements

Section overview

This section discusses the basic disclosures required by IFRS 7 in the financial statements.

3.1 Statement of financial position

3.1.1 Categories of financial assets and financial liabilities

The carrying amounts of each of the following categories, as defined in IFRS 9, must be disclosed either in the statement of financial position or in the notes:

- Financial assets at fair value through profit or loss, showing separately:
  - those designated as such on initial recognition; and
  - those classified as held for trading in accordance with IFRS 9.
- Financial assets at fair value through other comprehensive income
- Financial assets held at amortised cost
- Investments in equity instruments
- Financial liabilities at fair value through profit or loss, showing separately:
  - those designated as such on initial recognition; and
  - those classified as held for trading in accordance with IFRS 9.
- Financial liabilities measured at amortised cost

3.1.2 Loans and receivables at fair value through profit or loss

(a) **Disclosures**

If the entity has designated a loan or receivable (or group of loans or receivables) as at fair value through profit or loss, it should disclose the following:

(1) The maximum exposure to credit risk of the loan or receivable (or group of loans or receivables) at the reporting date

(2) The amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk

(3) The amount of change, during the period and cumulatively, in the fair value of the loan or receivable (or group of loans or receivables) that is attributable to changes in the credit risk of the financial asset

(4) The amount of the change in the fair value of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the loan or receivable was designated

(b) **Calculation**

The amount of any change in the fair value attributable to credit risk can be calculated as the amount of the change not attributed to market risk. That is:

[Amount of change in fair value attributed to credit risk] = [Total amount of change in fair value] – [Amount of change in fair value attributed to market risk]

(c) **Alternative method**

The standard allows the employment of an alternative method to calculate the amount of change in the fair value attributed to credit risk if the entity believes that such a method more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset.

(d) **Market risk**

Changes in market conditions that give rise to market risk include changes in an observed (benchmark) interest rate, commodity price, foreign exchange rate or index of prices or rates.

3.1.3 Financial liabilities at fair value through profit or loss

(a) **Disclosures**

If the entity has designated a financial liability as at fair value through profit or loss it should disclose the following:

(1) The amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability

(2) The difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation

(b) **Calculation**

The amount of any change in the fair value attributable to credit risk can be calculated as the amount of the change not attributed to market risk. That is:

[Amount of change in fair value attributed to credit risk] = [Total amount of change in fair value] – [Amount of change in fair value attributed to market risk]

(c) **Alternative method**

The standard allows the employment of an alternative method to calculate the amount of change in the fair value attributed to credit risk if the entity believes that such a method is more accurate.

(d) **Market risk**

Changes in market conditions that give rise to market risk include changes in a benchmark interest rate, the price of another entity's financial instrument, a commodity price, a foreign exchange rate or an index of prices or rates. For contracts that include a unit-linking feature, changes in market conditions include changes in the performance of the related internal or external investment fund.

The example below illustrates how an entity can arrive at the change in fair value attributable to credit risk by estimating the amount of change in fair value attributable to risks other than credit risk.

Context example: Credit risk and change in value

On 1 January 20X6, an entity issues a five-year bond with a par value of £200,000, and an annual fixed coupon rate of 7%. The coupon rate reflects the market SONIA rate and the credit spread associated with the bond at the time of the issue. At the time of the issue SONIA was 5%, implying a credit spread of 2%.

The price of the bond will subsequently change either due to change in SONIA (market risk) or due to a change in the credit spread (credit risk).

Thus a change in the fair value of the bond attributed to credit risk can be calculated by subtracting from the total change in the fair value the changes due to market risk (ie, due to changes in SONIA).

Suppose that on 31 December 20X6, the value of the bond has decreased to £196,651, as the SONIA has increased to 5.25%. The yield to maturity for the bond has now risen to 7.50%. The credit spread has now increased to 2.25% implying deterioration in the credit quality of the bond.

In order to calculate the change in the value of the bond due to changes in SONIA alone, we shall calculate the fair value of the bond, at the new SONIA of 5.25% assuming that the credit spread has remained at 2%. This means that we need to discount the remaining four payments using a discount rate of 7.25%.

Using this discount factor produces:

$(14{,}000/1.0725) + (14{,}000/1.0725^2) + (14{,}000/1.0725^3) + (14{,}000 + 200{,}000/1.0725^4) =$ £198,316

Total change in market value (£200,000 – £196,651)		£3,349
Change in market value due to market risk (£200,000 – £198,316)		£1,684
Difference in value due to credit risk (£198,316 – £196,651)	£1,665	

3.1.4 Reclassification

If an entity has reclassified a financial asset, previously measured at fair value as measured at cost or amortised cost or vice versa, it should **disclose the amount reclassified** into and out of each category and the **reason for that reclassification**.

3.1.5 Derecognition

An entity may have transferred financial assets in such a way that **part or all of the financial assets do not qualify for** derecognition. In such a case, the entity should **disclose** the following for each class of financial assets:

- The **nature** of the assets
- The nature of the **risksand rewards of ownership** to which the entity remains exposed
- When the entity continues to recognise all of the assets, the **carrying amounts** of the assets and of the associated liabilities
- When the entity continues to recognise the assets to the extent of its continuing involvement, the **total carrying amount of the original assets**, the **amount** of the assets that the entity **continues** to recognise, and the carrying amount of the **associated liabilities**

3.1.6 Collateral

An entity should disclose the following:

- The **carrying amount** of financial assets it has pledged as collateral for liabilities or contingent liabilities, including amounts that have been reclassified
- The **terms and conditions** relating to its pledge

When an entity holds collateral (of financial or non-financial assets) and is permitted to sell or re-pledge the collateral in the absence of default by the owner of the collateral, it shall disclose the following:

- The fair value of the collateral **held**
- The fair value of any such collateral **sold or re-pledged**, and whether the entity has an obligation to return it
- The **terms and conditions** associated with its use of the collateral

3.2 Profit or loss for the year

Items of income, expense, gains or losses

An entity should disclose the following items of income, expense, gains or losses either in the statement of profit or loss and other comprehensive income or in the notes:

(a) **Net gains or net losses** on:

(1) Financial assets or financial liabilities at fair value through profit or loss, showing separately those on financial assets or financial liabilities designated as such on initial recognition, and those on financial assets or financial liabilities that are classified as held for trading in accordance with IFRS 9

(2) Investments in equity instruments where gains are recognised in profit or loss for the period

(3) Held-to-maturity investments

(4) Loans and receivables

(5) Financial liabilities measured at amortised cost

(b) **Total interest income and total interest expense** (calculated using the effective interest method) for financial assets or financial liabilities that are not at fair value through profit or loss

(c) **Fee income and expense** (other than amounts included in determining the effective interest rate) arising from:

- financial assets or financial liabilities that are not at fair value through profit or loss; and
- trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans and other institutions.

(d) **Interest income on impaired financial assets**

(e) **The amount of any impairment** loss for each class of financial asset

4 Other disclosures

Section overview

This section discusses additional quantitative and qualitative disclosures in the financial statements.

4.1 Accounting policies

An entity should disclose, in the summary of significant accounting policies, the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements.

4.2 Hedge accounting

Hedge accounting is covered in later Chapters. The disclosures are dealt with in later Chapters.

4.3 Fair value

IFRS 7 retains the following general requirements in relation to the disclosure of fair value for those financial instruments **measured at amortised cost**:

- For each class of financial assets and financial liabilities an entity should disclose the **fair value of that class of assets and liabilities** in a way that permits it to be compared with its carrying amount.
- In disclosing fair values, an entity should group financial assets and financial liabilities into classes, but should **offset them only to the extent that their carrying amounts are offset in the statement of financial position**.

It also states that disclosure of fair value is not required where carrying amount is a reasonable approximation of fair value.

IFRS 13 provides disclosure requirements in respect of the fair value of financial instruments measured at fair values. It requires that information is disclosed to help users assess:

- For assets and liabilities measured at **fair value after initial recognition**, **the valuation techniques and inputs used to develop those measurements**
- For **recurring fair value measurements** (ie, those measured at each period end) using significant unobservable (Level 3) inputs, the **effect of the measurements on profit or loss** or other comprehensive income for the period

In order to achieve this, the following should be **disclosed as a minimum** for each class of financial assets and liabilities measured at fair value:

- The fair value measurement at the end of the period
- The level of the fair value hierarchy within which the fair value measurements are categorised in their entirety
- For assets and liabilities measured at fair value at each reporting date (recurring fair value measurements), the amounts of any transfers between Level 1 and Level 2 of the fair value hierarchy and reasons for the transfers
- For fair value measurements categorised within Levels 2 and 3 of the hierarchy, a description of the valuation techniques and inputs used in the fair value measurement, plus details of any changes in valuation techniques
- For recurring fair value measurements categorised within Level 3 of the fair value hierarchy:
  - A reconciliation from the opening to closing balances
  - The amount of unrealised gains or losses recognised in profit or loss in the period and the line item in which they are recognised
  - A narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs
- For recurring and non-recurring fair value measurements categorised within Level 3 of the fair value hierarchy, a description of the valuation processes used by the entity

An entity should also disclose its policy for determining when transfers between levels of the fair value hierarchy are deemed to have occurred.

Context example: Fair value disclosures

For financial assets and liabilities measured at fair value at the end of the reporting period, IFRS 13 requires quantitative disclosures about the fair value measurements for each class of financial assets and liabilities.

An entity might disclose the following for financial assets and financial liabilities (excludes comparatives and further quantitative disclosures in relation to fair value hierarchy):

Description	31.12.X5	Fair value measurements at the end of the reporting period using Level 1 inputs	Level 2 inputs	Level 3 inputs
	£'000	£'000	£'000	£'000
Trading portfolio assets	95	95		
Non-trading equity securities	73			73
Corporate bonds	175	25	150	
Designated at fair value	33		31	2
Investments in equity instruments	41	11	25	5
Derivatives – interest rate swaps	55		55	
Financial assets at fair value	472	131	261	80
Trading portfolio liabilities	60	40	20	
Designated at fair value	12		9	3
Derivatives – interest rate swaps	55		55	
Financial liabilities at fair value	127	40	84	3

5 Financial instruments risk disclosure

Section overview

An entity should disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the reporting date. These risks include, but are not limited to, credit risk, liquidity risk and market risk.

5.1 Types of risk

In undertaking transactions in financial instruments, an entity may assume or transfer to another party one or more different types of financial risk as defined below. The disclosures required by the standard show the extent to which an entity is exposed to these different types of risk, relating to both recognised and unrecognised financial instruments.

Credit risk	The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.
Currency risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.
Interest rate risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

Liquidity risk	The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities.
Loans payable	Loans payable are financial liabilities, other than short-term trade payables on normal credit terms.
Market risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and other price risk.
Other price risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.
Past due	A financial asset is past due when a counterparty has failed to make a payment when contractually due.

5.2 Qualitative disclosures

For each type of risk arising from financial instruments, an entity must disclose the following:

(a) The **exposures** to risk and how they arise

(b) Its **objectives**, policies and processes for managing the risk and the methods used to measure the risk

(c) **Any changes** in (a) or (b) from the previous period

5.3 Quantitative disclosures

For each financial instrument risk, summary quantitative data about risk exposure must be disclosed. This should be based on the information provided internally to key management personnel. More information should be provided if this is unrepresentative.

Information about credit risk must be disclosed by class of financial instrument:

(a) **Maximum exposure** at the year end

(b) Any **collateral** pledged as security

(c) In respect of the amount disclosed in (b), a **description** of collateral held as security and other credit enhancements

(d) Information about the **credit quality** of financial assets that are neither past due nor impaired

(e) Financial assets that are **past due or impaired**, giving an age analysis and a description of collateral held by the entity as security

(f) **Collateral and other credit enhancements** obtained, including the nature and carrying amount of the assets and policy for disposing of assets not readily convertible into cash

For **liquidity risk**, entities must disclose the following:

- A **maturity analysis** of financial liabilities
- A **description** of the way risk is managed

Disclosures required in connection with **market risk**:

- **Sensitivity analysis**, showing the effects on profit or loss of changes in each market risk
- If the sensitivity analysis reflects interdependencies between risk variables, such as interest rates and exchange rates, the method, **assumptions and limitations** must be disclosed

5.3.1 Credit risk disclosures in more detail

Information about credit risk must be disclosed by class of financial instrument:

(a) **Maximum exposure** at the year end, which for a financial asset is the gross carrying amount, net of:

- any amounts offset in accordance with IAS 32; and
- any impairment losses recognised in accordance with IFRS 9.

The maximum exposure to credit risk at the reporting date should be without taking account of any collateral held or other credit enhancements (eg, netting agreements that do not qualify for offset in accordance with IAS 32).

(b) In respect of the amount disclosed in (a), a **description** of collateral held as security and other credit enhancements.

(c) Information about the **credit quality** of financial assets that are neither past due nor impaired.

(d) Financial assets that are **past due or impaired**, giving an age analysis and a description of collateral held by the entity as security.

(e) **Collateral and other credit enhancements** obtained, including the nature and carrying amount of the assets and policy for disposing of assets not readily convertible into cash.

(f) **Analysis of financial assets** that are **individually determined to be impaired** as at the reporting date, including the factors the entity considered in determining that they are impaired.

The **activities that give rise to credit risk** and the associated maximum exposure to credit risk include, but are not limited to the following:

- **Grant of loans** to customers and placing deposits with other entities: Maximum exposure to credit risk is the carrying amount of related financial assets.
- **Derivative contracts**: When the resulting financial asset is measured at fair value, the maximum exposure to credit risk at the end of the reporting period will equal the carrying amount.
- **Grant of financial guarantees**: Maximum exposure to credit risk is the maximum amount the entity could have to pay if the guarantee is called on, which may be significantly greater than the amount recognised as a liability.
- **Making a loan commitment** that is irrevocable over the life of the facility or is revocable only in response to a material adverse change: If the issuer cannot settle the loan commitment net in cash or another financial instrument, the maximum credit exposure is the full amount of the commitment.

Additional disclosures

These include disclosures such as the following:

- Reconciliation of loss allowances
- Explanation of how significant changes in the gross carrying amount of financial instruments during the period contributed to changes in loss allowance
- Inputs, assumptions and techniques in estimating 12-month and lifetime expected credit losses including how forward looking information has been incorporated into the determination of expected credit losses
- Separate disaggregation by credit risk rating grades of the gross carrying amount
- Information about collateral, modified financial assets and write offs still subject to enforcement activity

5.4 Sensitivity analysis: more detail

The standard requires that an entity should disclose a sensitivity analysis for each type of market risk to which the entity is exposed.

The standard gives **two options** regarding disclosure of the sensitivity analysis.

Option 1

An entity should disclose the following:

(a) Sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date. Risk variables that are relevant to disclosing market risk include, but are not limited to:

- the yield curve of market interest rates, for example the SONIA rate. It may be necessary to consider both parallel and non-parallel shifts in the yield curve;
- foreign exchange rates;
- prices of equity instruments; and
- market prices of commodities.

(b) The methods and assumptions used in preparing the sensitivity analysis

(c) Changes from the previous period in the methods and assumptions used, and the reasons for such changes

The effect on profit or loss and equity of reasonably possible changes in the relevant risk variables may include changes in the prevailing interest rates for interest-sensitive instruments, and/or changes in currency rates for foreign currency financial instruments.

For interest rate risk, the sensitivity analysis might show separately the effect of a change in market interest rates on interest income and expenditure, on other items of profits and on equity.

Option 2

Alternatively, if an entity prepares a sensitivity analysis, such as value at risk, that reflects interdependencies between risk variables (eg, interest rates and exchange rates) **and uses it to manage financial risks**, it may use that sensitivity analysis in place of the analysis specified in the previous paragraph. In this case the entity should also disclose:

- an explanation of the method used in preparing such a sensitivity analysis, and of the main parameters and assumptions underlying the data provided; and
- an explanation of the objective of the method used and of limitations that may result in the information not fully reflecting the fair value of the assets and liabilities involved.

It is important for auditors to test this sensitivity analysis and document this on their files. For example, they should document how they gained comfort over the underlying assumptions and sensitivity analysis methodology. Auditing financial instruments is covered in later Chapters.

5.5 Other market risk disclosures

Other market risk is **any market risk which is not currency or interest rate risk**. When the disclosure of sensitivity analyses discussed above are unrepresentative of a risk inherent in a financial instrument (for example because the year-end exposure does not reflect the exposure during the year), the entity shall disclose that fact and the reason it believes the sensitivity analyses are unrepresentative.

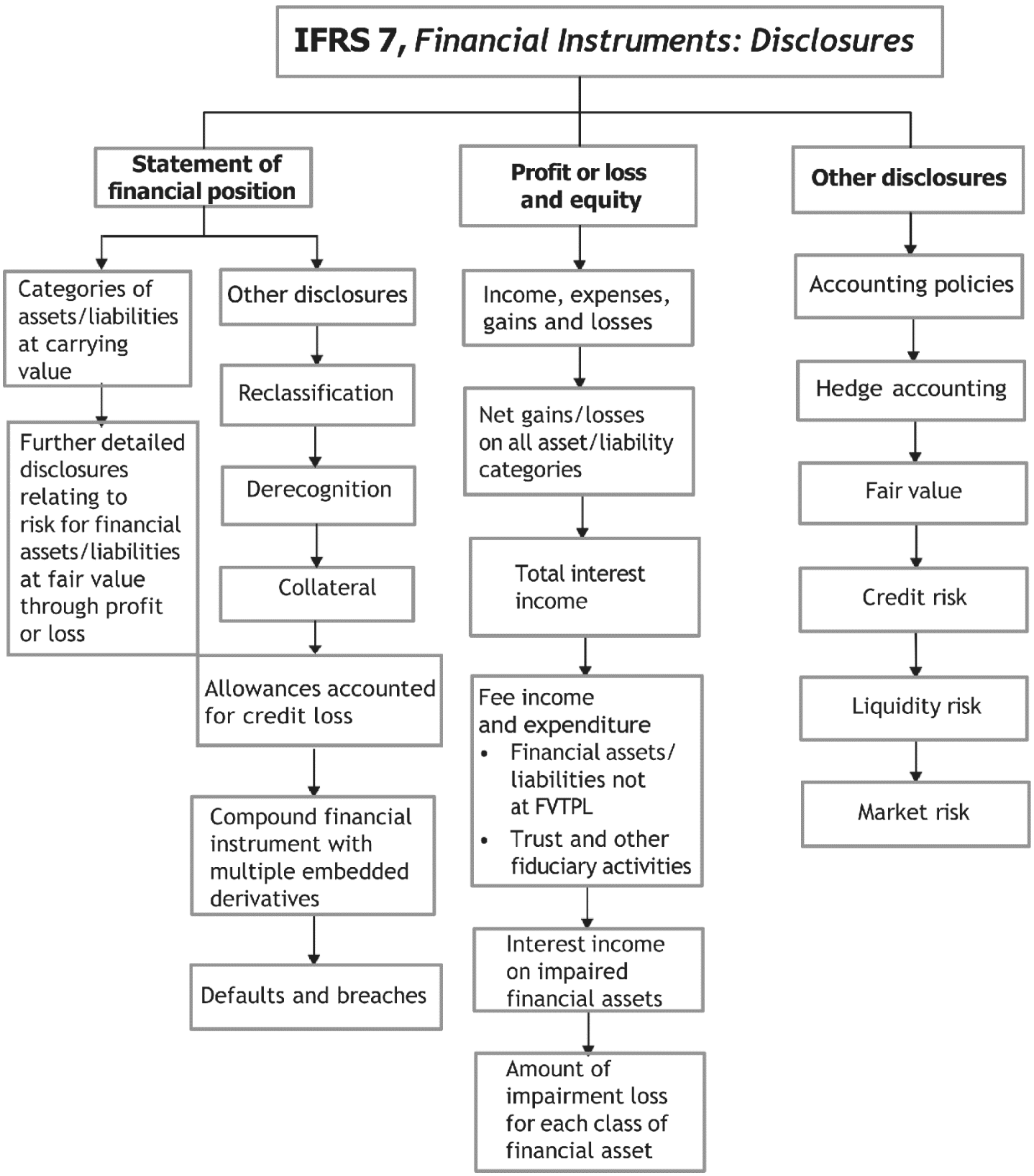
Professional skills focus: Assimilating and using information

It can be seen that a great deal of information needs to be assimilated and applied in order to carry out a sensitivity analysis.

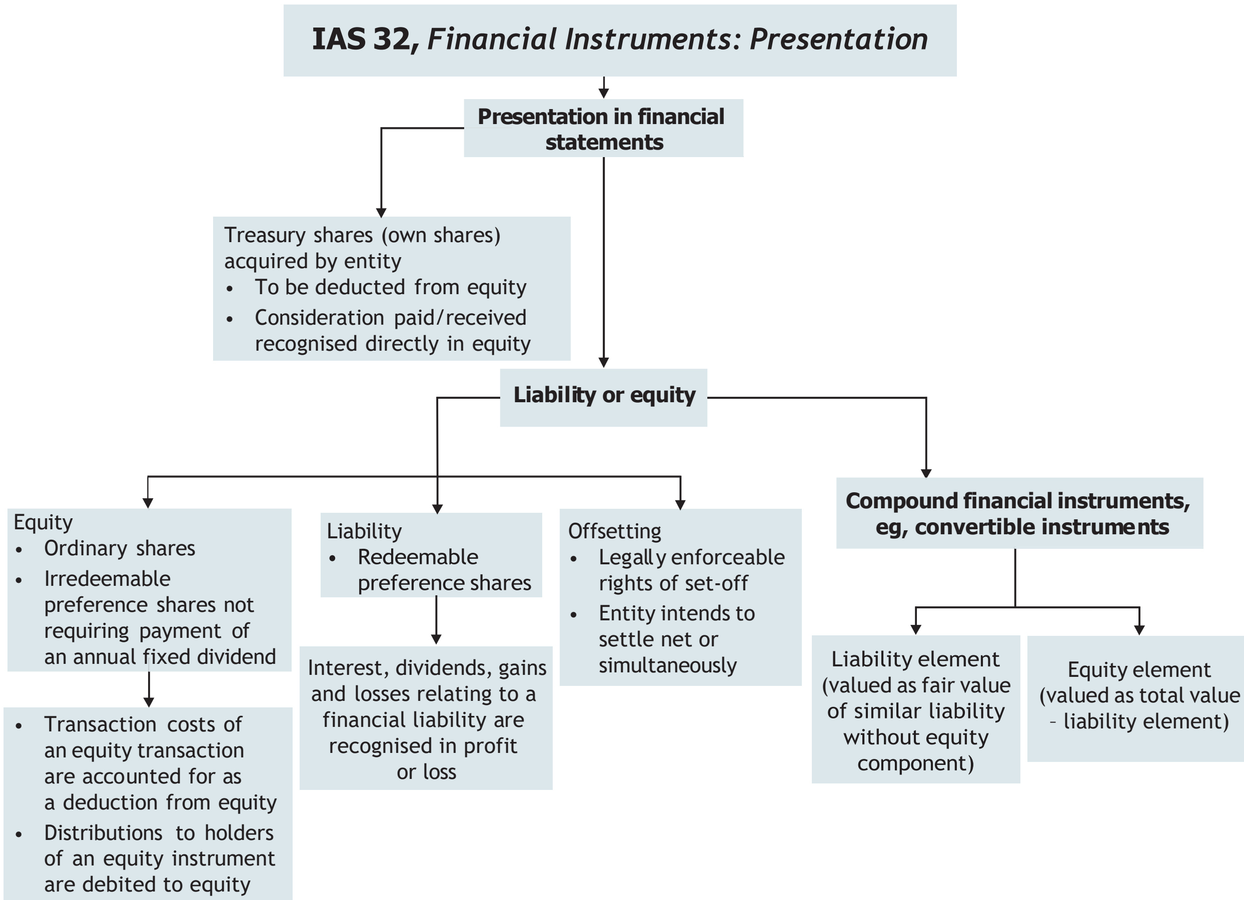
Professional skills focus: Concluding, recommending and communicating

Many financial instruments, particularly those held at fair value, are risky. Risk is not necessarily a negative, provided it is communicated to users and disclosures are transparent.

Summary



IFRS 7, *Financial Instruments: Disclosures*
Statement of financial position
Profit or loss and equity
Other disclosures
Categories of assets/liabilities at carrying value
Further detailed disclosures relating to risk for financial assets/liabilities at fair value through profit or loss
Other disclosures
Reclassification
Derecognition
Collateral
Allowances accounted for credit loss
Compound financial instrument with multiple embedded derivatives
Defaults and breaches
Income, expenses, gains and losses
Net gains/losses on all asset/liability categories
Total interest income
Fee income and expenditure
• Financial assets/ liabilities not at FVTPL
• Trust and other fiduciary activities
Interest income on impaired financial assets
Amount of impairment loss for each class of financial asset
Accounting policies
Hedge accounting
Fair value
Credit risk
Liquidity risk
Market risk


IAS 32, *Financial Instruments: Presentation*
Presentation in financial statements
Treasury shares (own shares) acquired by entity
• To be deducted from equity
• Consideration paid/received recognised directly in equity
Liability or equity
Equity
• Ordinary shares
• Irredeemable preference shares not requiring payment of an annual fixed dividend
• Transaction costs of an equity transaction are accounted for as a deduction from equity
• Distributions to holders of an equity instrument are debited to equity
Liability
• Redeemable preference shares
Interest, dividends, gains and losses relating to a financial liability are recognised in profit or loss
Offsetting
• Legally enforceable rights of set-off
• Entity intends to settle net or simultaneously
Compound financial instruments, eg, convertible instruments
Liability element (valued as fair value of similar liability without equity component)
Equity element (valued as total value - liability element)

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	What issues arise when distinguishing debt and equity? (Topic 1)
2.	IFRS 7 requires certain disclosures relating to risk. What are the three main types of risk identified by the standard? (Topic 2)
3.	What disclosures does IFRS 7 require in relation to loans and receivables at fair value through profit or loss? (Topic 3)
4.	What are IFRS 7's minimum disclosure requirements in respect of the fair value of financial instruments measured at fair value, on recognition and subsequently? (Topic 4)
5.	In relation to risk, can you distinguish qualitative disclosures and quantitative disclosures? (Topic 5)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Short-answer question	This is a quick test of knowledge of IFRS 7 disclosures.
Warburton	This is revision of the IAS 32 requirement regarding convertible bonds.
Erubus	This is a further exercise in separating the liability and equity components, but slightly more complex.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted the self-test questions, you can continue your studies by moving onto the next chapter. In later chapters, we will recommend questions from the Question Bank for you to attempt.

1 IAS 32, *Financial Instruments: Presentation*

Presentation of equity and liabilities

- Classification as financial asset, financial liability or equity instrument – **IAS 32.15–16**
- Definitions – **IAS 32.11**

- Contractual obligation and substance of instrument – **IAS 32.17–18**
- Settlement options – **IAS 32.26–27**
- Treasury shares – **IAS 32.33–34**
- Interest, dividends, losses and gains – **IAS 32.35–36**
- Offsetting – **IAS 32.42**

Compound instruments

- Recognising liability and equity elements – **IAS 32.28**
- Example of convertible bonds – **IAS 32.29–30**
- Calculation of liability and equity elements – **IAS 32.31–32**

2 IFRS 7, *Financial Instruments: Disclosures*

- Statement of financial position disclosures – **IFRS 7.8–19**
- Statement of profit or loss and other comprehensive income and statement of changes in equity disclosures – **IFRS 7.20**
- Nature and extent of risks arising from financial instruments
  - Purpose of disclosures – **IFRS 7.31–32**
  - Qualitative disclosures – **IFRS 7.33**

Answer the following questions.

1 Disclosure

What is the main objective of the disclosure requirements of IFRS 7?

2 IFRS 7

How does IFRS 7 define the following?

2.1 Liquidity risk

2.2 Market risk

3 Sensitivity analysis

Why does IFRS 7 require entities to disclose sensitivity analysis to market risk?

4 Warburton

The Warburton Company issued £10 million of convertible bonds at par on 31 December 20X7. Interest is payable annually in arrears at a rate of 7%. The bonds are redeemable on 31 December 20X9. The bonds can be converted at any time up to maturity into 12.5 million ordinary shares.

At the time of issue, the market interest rate on debt with a similar credit status and the same cash flows, but without conversion rights, was 10% per annum.

Requirement

What carrying amount should be recognised for the liability in the statement of financial position of Warburton at 31 December 20X7 in respect of the convertible bond, in accordance with IAS 32, *Financial Instruments: Presentation*?

5 Erubus

The Erubus Company issued £15 million of 6% convertible bonds at par on 31 December 20X7. The bonds are redeemable at 31 December 20Y1. The bonds can be converted by their holders any time up to maturity into ordinary shares of Erubus.

At 31 December 20X7 the present value of the future capital and interest payments discounted at the prevailing market interest rate for similar bonds without the conversion rights is £13 million.

The transaction costs directly attributable to the issue of the convertible bonds were £400,000. These costs are deductible against Erubus's taxable profits. Erubus's tax rate is 25%.

Requirement

What increase in equity should be recognised in the statement of financial position of Erubus at 31 December 20X7 as a result of the issue of the convertible bonds, in accordance with IAS 32, *Financial Instruments: Presentation*?

Note: Some of the requirements of IAS 32 relate to derivatives and embedded derivatives. These will be tested after you have covered those topics in Chapter 16.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

Refer to the definitions of financial assets and liabilities.

- **Physical assets**: Control of these creates an opportunity to generate an inflow of cash or other assets, but it does not give rise to a present right to receive cash or other financial assets.
- **Prepaid expenses, etc**: The future economic benefit is the receipt of goods/services rather than the right to receive cash or other financial assets.

Answer to Interactive question 2

Liability. The preference shares require regular distributions to the holders but more importantly have the debt characteristic of being redeemable. Therefore, according to **IAS 32**, *Financial Instruments: Presentation* they must be classified as liability.

Answer to Interactive question 3

The convertible bond is not a compound financial instrument, as it is not settled in a fixed amount of shares. It should instead be wholly classified as a liability.

The convertible redeemable preference shares are compound instruments. They have a financial liability component, as there is an obligation to deliver cash through dividends and on redemption in five years' time to deliver either cash or equity instruments (through the holder's right to convert into equity).

Answer to Interactive question 4

The liability component is computed as the present value of the maximum potential cash flows discounted at 10%.

Time	Cash flow	Discount factor @ 10%	PV
	£		£
1	4,000	0.909	3,636
2	54,000	0.826	44,604
			48,240

The equity component of the gross proceeds is therefore (£50,000 – £48,240) £1,760.

The issue costs of £1,000 are split in the ratio 48,240:1,760 ie, £965 is netted against the liability and £35 is netted against the equity.

The entries are therefore:

		£	£
DEBIT	Cash	50,000	
CREDIT	Liability		48,240
CREDIT	Equity		1,760

CHAPTER 15

and

CREDIT	Cash		1,000
DEBIT	Liability	965	
DEBIT	Equity	35	

The net liability initially recognised is £47,275. This is then amortised to £50,000 over the next 2 years at an effective interest rate of 11.19% (the IRR of the cash flows of £47,275, –£4,000 and –£54,000) as follows:

Year	B/fwd £	Interest expense at 11.19% £	Cash flow £	C/fwd £
1	47,275	5,290	(4,000)	48,565
2	48,565	5,435	(4,000)	50,000

Answer to Interactive question 5

The contract is a financial asset or financial liability, even though the entity must settle it by issuing its own equity. It is not an equity instrument, as it is settled using a variable number of the entity's own equity instruments.

Answer to Interactive question 6

Offsetting is not appropriate.

Each of the financial instruments has its own terms and conditions and may be transferred or settled separately. The risks of the financial instruments are different.

They should not be offset unless they meet the criteria in IAS 32 (legal right of set-off and intention to settle net), which is unlikely. However, disclosure of the relationship between the two financial instruments would provide useful information to users of the financial statements.

Answer to Interactive question 7

Emporium's finance director is incorrect. A financial liability for the present value of the maximum amount payable to shareholders should be recognised in the financial statements as of 31 October 20X8. At 31 October 20X8, the rights are equivalent to a written put option because they represent for Emporium a purchase obligation which gives shareholders the right to sell the entity's own equity instruments for a fixed price. The fundamental principle of IAS 32 *Financial Instruments: Presentation* is that a financial instrument should be classified as either a financial liability or an equity instrument according to the substance of the contract, not its legal form, and the definitions of financial liability and equity instrument. IAS 32 states that a contract which contains an entity's obligation to purchase its own equity instruments gives rise to a financial liability, which should be recognised at the present value of its redemption amount. IAS 32 also states that a contractual obligation for an entity to purchase its own equity instruments gives rise to a financial liability for the present value of the redemption amount even if the obligation is conditional on the counterparty exercising a right to redeem, as is the case with the bonus issue of Emporium.

Answers to Self-test questions

1 Disclosure

The main objective of the disclosure requirements of IFRS 7 is to show the significance of financial instruments for an entity's financial position and financial performance and qualitative and quantitative information about exposure to risks arising from financial instruments.

2 IFRS 7

2.1 **Liquidity risk** is defined as the risk that an entity will encounter difficulty in meeting the obligations associated with its financial liabilities.

2.2 **Market risk** is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices.

3 Sensitivity analysis

Sensitivity analysis helps users of financial statements to evaluate the effect of possible changes in the entity's financial position and financial performance due to changes in market risk factors.

4 Warburton

£9,479,339

IAS 32.28 requires the separation of the compound instrument into its liability and equity elements. IAS 32.31 and .32 explain how this separation should be made. IAS 32.AG30 – AG35 explain the application of this principle.

Thus the liability is (£0.7m/1.10) + (£10.7m/1.10^2) = £9,479,339.

5 Erubus

£1,960,000

IAS 32.28 requires the separation of a compound instrument into liability and equity elements where this is appropriate.

IAS 32.35 and 32.37 require that transaction costs of an equity transaction shall be deducted from equity net of tax.

IAS 32.38 requires that transaction costs directly attributable to a compound financial instrument should be allocated to the liability and equity components in proportion to the allocation of the proceeds.

Liability component of gross proceeds: £13m Equity component of gross proceeds: £2m Issue costs are £400,000, allocated:

Liability component (13/15) £346,667 Equity component (2/15) £53,333

The initial liability recognised is therefore (£13m – £346,667) £12,653,333.

The equity component is (£2m – (£53,333 – 25% tax relief on £53,333) £1,960,000

Note that tax relief on the issue costs allocated to the liability component will be given, as they are amortised against profit or loss. Initially they attract no relief and so there is no tax adjustment for them in the original allocation of the issue costs.

Requires the separation of a compound instrument into liability and equity elements where this is appropriate.

IAS 32.35 and 32.37 require that transaction costs of an equity transaction shall be deducted from equity net of tax.

IAS 32.38 requires that transaction costs directly attributable to a compound financial instrument should be allocated to the liability and equity components in proportion to the allocation of the proceeds.

Liability component of gross proceeds: £13m Equity component of gross proceeds: £2m Issue costs are £400,000, allocated:

Liability component (13/15) £346,667 Equity component (2/15) £53,333

The initial liability recognised is therefore (£13m – £346,667) £12,653,333.

The equity component is (£2m – (£53,333 – 25% tax relief on £53,333) £1,960,000

Note: Tax relief on the issue costs allocated to the liability component will be given, as they are amortised against profit or loss. Initially they attract no relief and so there is no tax adjustment for them in the original allocation of the issue costs.

Chapter 16

Financial instruments: recognition and measurement

Introduction

Learning outcomes

- Identify and explain current and emerging issues in corporate reporting
- Determine and calculate how different bases for recognising, measuring and classifying financial assets and financial liabilities can impact upon reported performance and position
- Evaluate the impact of accounting policies and choice in respect of financing decisions for example hedge accounting and fair values
- Explain and appraise accounting standards that relate to an entity's financing activities which include: financial instruments; leasing; cash flows; borrowing costs; and government grants

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
1	**Introduction and overview of earlier studies** Financial instruments, especially derivatives, can significantly change the risk profile of organisations. The IASB has therefore paid a great deal of attention to developing IFRS 9, *Financial Instruments*	**Approach** Although you have studied IFRS 9 at Professional Level, the subject is treated in much more depth and complexity. It is essential, therefore that you have a clear grasp of the basics, so do not skip or skim read this section. **Stop and think** Section 1.2 is a 'stop and think' section, stepping back before looking at the detail.	All the topics covered in this section are assumed knowledge and can be tested in the exam.	**IQ3: Loan** This is a very straightforward question. If you struggle with it, you need to go back to your material from earlier studies and revise.
2	**Recognition, classification and derecognition** This section builds on your previous studies, which only	**Approach** Note that IFRS 9 requires that financial assets are classified as	This is a key area and frequently tested. You could get a financial reporting	**IQ4: Contractual cash flows and selling financial assets** While this question is only short it is

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
	dealt with financial assets and liabilities at amortised cost.	measured at either: • amortised cost; or • fair value through other comprehensive income; or • fair value through profit or loss. Your earlier studies only dealt with amortised cost. **Stop and think** What is the basis for classification?	question requiring adjustments to the financial statements with a substantial number of adjustments based around financial instruments. You must know the business model test in detail, as it could easily come up.	essential you do it as it does test whether you have understood the issue.
3	**Measurement** This section deals with initial measurement (cost = fair value), the treatment of transaction costs and subsequent measurement. Subsequent measurement depends on how the instrument has been classified on initial recognition (amortised cost, FVTPL or FVTOCI).	**Approach** Work through this section very carefully, paying particular attention to the worked examples, especially the debt instrument and FVTOCI. With liabilities make sure you fully understand section 3.9.2 on credit risk, which may seem counterintuitive. **Stop and think** How are transaction costs recognised?	Any of the topics in the worked examples could come up in the exam and will be of the same level of difficulty.	**IQ8: Investment in listed shares** Use the summary table in paragraph 3.6 to help you with this and other questions. This table will be useful in revising for your exam.
4	**Credit losses (impairment)** This deals with the complex area of credit losses (impairment). IFRS 9 uses an expected loss model, which is a change from the earlier incurred loss model.	**Approach** Make sure you understand what is meant by: • credit loss • expected credit loss • lifetime expected credit loss • 12 month expected credit loss	This area could be examined within the context of a scenario question requiring adjustments to the financial statements.	**IQ12: Modification** This deals with a situation where the terms of the loan are modified and credit risk increases.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
		Stop and think What is meant by Stages 1, 2 and 3?		
5	**Application of IFRS 13 to financial instruments** IFRS 13 works its way into many standards, particularly IFRS 9, because so many financial instruments are measured at fair value.	**Approach** Skim quickly through para. 5.1, which should be familiar to you. Focus more on fair value of financial assets (5.2 and financial liabilities). **Stop and think** The approach to fair valuing financial liabilities and own equity shares may differ from financial assets.	The interaction of IFRS 9 and IFRS 13 has been tested in depth, for example, the valuation of unquoted shares, and also in the context of quoted shares, for example in July 2020.	**IQ13: Fair value of liability** This question requires fair valuing a liability in the books of two companies with different credit ratings.
6	**Derivatives and embedded derivatives** Derivatives are financial instruments whose value changes in response to a change in the value of an underlying security, commodity, currency, index or other financial instrument(s). They normally require a zero, or small, initial net investment and are settled at a future date.	**Approach** Work carefully through section 6 on derivatives including all the worked examples, interactive questions and illustrations. Note in particular the need to separate the host instrument from the embedded derivative, unless the host contract is a financial asset within the scope of IFRS 9, in which case the whole contract is measured at fair value through profit or loss. **Stop and think** What instruments qualify as	Derivatives commonly examined include swaps and options.	**IQ15: Embedded derivatives** This question has two embedded derivatives, one which needs to be separated from the host contract and one that doesn't. There is a useful summary diagram in paragraph 6.6 that will guide you with this.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
		derivatives for accounting purposes? What is the accounting treatment of derivatives?		
7	**Current developments** Now that IFRS 9 is fully examinable, there is less going on in the area of current developments, the main one being financial instruments with the characteristics of equity.	**Approach** Skim read this for background only. **Stop and think** Why is the debt/equity distinction important?	This will not be examined in detail as it is only at the Discussion Paper stage.	N/A

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Introduction and overview of earlier studies

Section overview

This section gives a chapter overview and summarises the material covered at Professional Level in order to consolidate student knowledge before more advanced issues are covered.

- **IFRS 9, *Financial Instruments***
  - Financial assets and financial liabilities are classified on initial recognition. This classification drives subsequent measurement of the instruments.
  - Financial assets are classified as either measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss.
  - Reclassifications are permitted only if there is a change in the entity's business model for holding the financial asset.
  - The financial statements should reflect the general pattern of deterioration or improvement in the credit quality of financial instruments within the scope of IFRS 9. The impairment model in IFRS 9 is based on the premise of providing for expected losses.
- **IAS 39, *Financial Instruments: Recognition and Measurement***

- The IAS 39 rules on hedging may still be applied, and are therefore covered in next Chapter.

1.1 Introduction

The purpose of this chapter is to provide thorough coverage of the accounting treatment of financial instruments. The main presentation and disclosure requirements as detailed in IAS 32, *Financial Instruments: Presentation* and IFRS 7, *Financial Instruments: Disclosures* together with certain aspects of recognition and measurement were covered at Professional Level and revisited in earlier chapter. This chapter extends the coverage of recognition and derecognition of financial assets and liabilities, and their initial and subsequent measurement and impairment, and finally discusses particular issues relating to the definition of derivatives and the accounting treatment of derivatives and embedded derivatives.

1.2 What are financial instruments?

Before looking at formal definitions and technical details, it is worth stepping back and thinking clearly about what financial instruments are and what they are for. We can start by demystifying some of the definitions:

Financial asset: an asset can be defined in simple terms as something you own or a favour that you can call in; similarly a financial asset can be defined as money that you own, or are owed. You can also own shares in a company. You have paid for the shares, and the company you have invested in owes you something of monetary value in return.

Financial liability: the party who owes you the money has a liability equal to your financial asset.

Equity investment: if the company is solvent, this is your share of the amount left over after deducting the liabilities from the assets.

It follows from the above that a **financial asset of one entity** is **either** a **financial liability or equity of another entity.** This is reflected in the formal definition of a financial instrument: "**A financial instrument** is any **contract** that gives rise to a **financial asset of one entity and a financial liability or equity instrument of another entity**" (IAS 32: para. 11). The new word in the formal definition is **contract:** this is what distinguishes financial instruments from other assets and liabilities.

Types of financial instruments: financial instruments can be divided into three basic types according to the rights and obligations they carry:

- Debt instruments (including receivables)
- Equities (for example shares)
- **Derivatives:** these are contracts with negligible or zero initial net value and subsequent fair value changes depending on the value of the underlying assets. Derivatives can be **either assets or liabilities** depending on whether there is a gain or loss on the contract.

Two further terms are worth introducing at this stage, as they are not particularly intuitive.

Bond holder = Lender (Imagine, if it helps, holding in your hand the contract in which the debtor agrees to pay you back.)

Bond issuer = Borrower (As with shares, a bond is issued to raise cash. You owe this to the lender, who is holding your contract.)

Finally, a term that comes up in many definitions concerning financial instruments is **accounting mismatch.** This is a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognising gains or losses on them on different bases. IFRS® Standards occasionally have rules which enable an accounting mismatch to be eliminated, for example hedging, or designating a financial asset at fair value through profit or loss if this would eliminate the mismatch.

1.2.1 Summary: features of financial instruments

Category	Rights or obligations	Asset or (liability) for:	Example
Debt	Defined amount and timing	Lender/holder (Borrower/payer)	Bond Receivable
Equity	Residual rights (in assets less liabilities), obligation only while solvent	Investor/shareholder (No liability within scope of IFRS 9)	Share
Derivative	Fair value of underlying	Gain (Loss)	Options, swaps, futures

1.2.2 Summary: recognition of financial assets and liabilities

The category of financial instrument and the rights and/or obligations associated with it, determine how it is measured on recognition and subsequently. We will look at recognition and measurement in detail below. For now, here are summaries to relate to the above table. As we have seen, debt instruments and derivatives can be financial assets or financial liabilities, but an equity instrument can only be a financial asset:

Financial assets

		Initial measurement (IFRS 9: para. 5.1.1)	Subsequent measurement (IFRS 9: paras. 4.1.2–4.1.5, 5.7.5)
1	**Investments in debt instruments** Business model approach: (a) Held to collect contractual cash flows; and cash flows are solely principal and interest	Fair value + transaction costs	Amortised cost
	(b) Held to collect contractual cash flows and to sell; and cash flows are solely principal and interest	Fair value + transaction costs	Fair value through other comprehensive income (with reclassification to profit or loss (P/L) on derecognition) NB: interest revenue calculated on amortised cost basis recognised in P/L
2	**Investments in equity instruments not 'held for trading'** (optional irrevocable election on initial recognition)	Fair value + transaction costs	Fair value through other comprehensive income (no reclassification to P/L on derecognition) NB: dividend income recognised in P/L
3	**All other financial assets** (and any financial asset if this would eliminate or significantly reduce an ' accounting mismatch')	Fair value (transaction costs expensed in P/L)	Fair value through profit or loss

Financial liabilities

		Initial measurement (IFRS 9: para. 5.1.1)	Subsequent measurement (IFRS 9: para. 4.2.1)
1	**Most financial liabilities** (eg, trade payables, loans, preference shares classified as a liability)	Fair value less transaction costs	Amortised cost
2	**Financial liabilities at fair value through profit or loss** • 'Held for trading' (short-term profit making) • Derivatives that are liabilities • Designated on initial recognition at 'fair value through profit or loss' to eliminate/significantly reduce an 'accounting mismatch'	Fair value (transaction costs expensed in P/L)	Fair value through profit or loss

	• A group of financial liabilities (or financial assets and financial liabilities) managed and performance evaluated on a fair value basis in accordance with a documented risk management or investment strategy		

Professional skills focus: Assimilating and using information

In exam questions on financial instruments at Advanced Level, you will often be presented with a great deal of seemingly complex information, which you must analyse. It helps to have the principles in the above summary in mind or to hand in order to avoid getting lost or overwhelmed.

Professional skills focus: Structuring problems and solutions

The above summary may also play a useful role in structuring problems. What is the nature and purpose of the financial instrument? How is it valued?

1.2.3 Further points forward from Professional Level

(a) A **compound financial instrument** (that is, one that has features of both debt and equity) should be **split into its component parts** according to their substance at the date that it is issued.

(b) **Interest, dividends, losses or gains** relating to a financial instrument (or a component) that is a financial liability should be **recognised** as income or expense **in profit or loss**.

(c) **Dividend distributions** paid to holders of an equity instrument should be debited **directly to equity, net of any related income tax benefit**. These should be presented in the statement of changes in equity.

(d) **Financial assets and financial liabilities** should generally be **presented as separate items** in the statement of financial position. No offsetting is allowed except where it is required because an entity has a legally enforceable right to set off recognised amounts and the entity intends to settle on a net basis, or to realise the asset and settle the liability simultaneously.

1.3 Practical implications for key ratios

The type of financial instrument, how it is measured and where changes in value are measured have important effects on key ratios. The classification of financial instruments as debt versus equity is particularly important with items that are financial liabilities or equity as the presentation of the two items and associated financial effects are very different.

If a financial instrument is classified as a financial liability (debt) it will be reported within current or non-current liabilities. Non-current liabilities are relevant in determining an entity's gearing ie, the proportion of debt finance versus equity finance of a business, and therefore risk to ordinary equity holders.

Distributions relating to instruments classified as financial liabilities are categorised as finance cost, having an impact on reported profitability.

If a financial instrument is classified as equity, reported gearing will be lower than if it were classified as a financial liability. However, classification as equity is sometimes viewed negatively as it can be seen as a dilution of existing equity interests.

Distributions on instruments classified as equity are charged to equity and therefore do not affect reported profit.

If a company elects for changes in value on an equity instrument to be recorded in other comprehensive income, rather than profit or loss, this will affect key profitability ratios. The requirement for such an election to be irrevocable prevents manipulation by booking gains to profit or loss one year and losses to other comprehensive income in the following year.

Classification of instruments can also have financial implications for businesses. For example, debt covenants on loans from financial institutions often contain clauses that reported gearing cannot exceed a stated figure, with penalties or call-in clauses if it does. Companies with high gearing may also find it harder to get financing or financing may be at a higher interest rate.

High gearing is particularly unpopular in the current economic climate and there have been high profile cases of companies that have been pressed to sell off parts of their business to reduce their 'debt mountains' eg, Telefónica SA, the Spanish telecoms provider, selling O_2 Ireland to Hutchison Whampoa (the owner of the '3' telephone network).

Interactive question 1: Classification

For each of the below instruments, identify whether it should be classified as a financial liability or as part of equity, explaining the reason for your choice.

1.1 Redeemable preference shares with a coupon rate of 8%. The shares are redeemable on 28 February 20X9 at a premium of 10%.

1.2 A grant of share options to senior executives. The options may be exercised from 28 February 20X8.

See **Answer** at the end of this chapter.

Interactive question 2: Transactions covered by IFRS 9

Should the following be recognised under IFRS 9?

1.1 A guarantee to replace or repair goods sold by a business in the normal course of business

1.2 A firm commitment (order) to purchase a specific quantity of cocoa beans for use in manufacturing

1.3 A forward contract to purchase cocoa beans at a specified price and quantity on a specified date

See **Answer** at the end of this chapter.

1.4 Amortised cost: revision

The **amortised cost** category applies to an asset held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and where the contractual terms of the asset give rise to cash receipts of interest and capital on specific dates. This applies to most debt instruments. Such assets are measured at **amortised cost** using the **effective interest method**.

Amortised cost is:

- the initial amount recognised for the financial asset

- less any repayments of the principal sum
- plus any amortisation

The amount of amortisation should be calculated by applying the effective interest method to spread the financing cost (that is the difference between the initial amount recognised for the financial asset and the amount receivable at maturity) over the period to maturity. The amount amortised in respect of a financial asset should be recognised as income in profit or loss.

Definition

Effective interest rate: The rate that exactly discounts estimated future cash payments or receipts through the expected life of the instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability.

You may be required to calculate the effective interest rate in the exam, so it is important that you study the worked example below carefully.

Worked example: Effective interest rate

An entity acquires a 6% coupon bond paying interest on an annual basis; it is redeemable in four years' time at its par value of £100. The current market price of this bond is £105 per £100 nominal value.

Requirement

Calculate the effective interest rate of this bond.

Solution

The RATE excel function is used to calculate the effective interest rate of a bond. To calculate the RATE, the following variables need to be input to the RATE function:

Nper = the number of periods

Pmt = the amount (of interest) paid in any single period

Pval = the present value of the asset (its market price), **inserted as a negative number**

Fval = the future value (the amount paid at maturity). Type and guess **can be left blank.**

This will give the effective interest rate (known as the yield to maturity) over a given period.

Alternatively, type **=RATE(** to begin the function entry then insert the number of periods, the payment made in each period, the present value (as a negative value) and the future value, and end by inserting a closed bracket).

=RATE(B1,B2,B3,B4)

	A	B
1	Nper = the number of periods	4
2	Pmt = the amount (of interest) paid in any single period	6
3	Pval = the present value of the asset (its market price)	-105
4	Fval = the future value (the amount at maturity)	100
5	Effective interest rate	0.046

CHAPTER 16

In the Corporate Reporting exam, the amount amortised in respect of a financial asset should be recognised as income in profit or loss using the effective rate of interest (here 4.6%) as this represents the true return on the bond to maturity. The 6% coupon rate in this example is not the true return on the bond as it does not take account of the difference between the initial amount recognised for the financial asset (£105) and the amount receivable at maturity (£100).

Worked example: Amortised cost

An entity acquires a zero coupon bond with a nominal value of £20,000 on 1 January 20X6 for £18,900. The bond is quoted in an active market and broker's fees of £500 were incurred in relation to the purchase. The bond is redeemable on 31 December 20X7 at a premium of 10%. The effective interest rate on the bond is 6.49%.

Requirement

Set out the journals to show the accounting entries for the bond until redemption if it is classified as being held at amortised cost. The entity has a 31 December year end.

Solution

On 1 January 20X6

		£	£
DEBIT	Financial asset (£18,900 plus £500 broker fees)	19,400	
CREDIT	Cash		19,400

On 31 December 20X6

		£	£
DEBIT	Financial asset (£19,400 × 6.49%)	1,259	
CREDIT	Interest income		1,259

On 31 December 20X7

		£	£
DEBIT	Financial asset ((£19,400 + £1,259) × 6.49%)	1,341	
CREDIT	Interest income		1,341
DEBIT	Cash	22,000	
CREDIT	Financial asset		22,000

1.4.1 Loan

A financial asset classified as a loan should also be measured at amortised cost using the effective interest method.

Amortisation should be recognised as income in profit or loss.

Most financial assets that meet this classification are simple receivables and loan transactions.

Interactive question 3: Loan

Hallowes plc has agreed to lend a customer £9,500 on 1 January 20X2 subject to the following terms:

- The loan is repaid on 31 December 20X4 in full.
- Three interest payments of £1,000 are paid on 31 December each year.

Hallowes plc incurred £250 of legal fees in agreeing the loan documentation with the customer. The effective rate of interest on the loan is 9.48%.

Requirement

Demonstrate by journal entries how the loan should be recorded in the financial statements of Hallowes plc for the year ended 31 December 20X2 and subsequent years.

See **Answer** at the end of this chapter.

2 Recognition, classification and derecognition

Section overview

- This section deals with recognition, classification and derecognition of financial assets and financial liabilities.
- IFRS 9 requires an entity to recognise financial assets and financial liabilities when it **becomes a party** to the contractual provisions of the instrument rather than when the contract is settled.
- IFRS 9 requires that financial assets are **classified as measured** at either:
  - **amortised cost**;
  - **fair value through other comprehensive income**; or
  - **fair value through profit or loss**.

Subsequent measurement depends on the category into which financial assets and financial liabilities are classified on origination.

- There is an **option to designate** a financial asset **at fair value through profit or loss** to **reduce or eliminate an 'accounting mismatch'** (measurement or recognition inconsistency).
- Financial assets are measured at **amortised cost** if: the asset is held within a business model whose objective is to collect contractual cash flows; and the cash flows are solely payments of principal and interest on the principal amount outstanding.
- Holdings of debt instruments are measured at **fair value through other comprehensive income** if: the asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets; and cash flows are solely payments of principal and interest on the principal amount outstanding.
- Financial **liabilities** are classified as being measured at **fair value through profit or loss**, or **amortised cost**.
- Reclassification of financial assets **is permitted only if the business model within which they are held changes**.
- Financial assets are derecognised when the **contractual rights** to the cash flows **expire** or the entity **passes** substantially all the **risks and rewards** of ownership to another party. Rights and obligations are recognised to reflect continuing involvement with the financial

asset that has been transferred. Financial liabilities are derecognised when they are **extinguished** ie, when they are discharged, expired or cancelled.

- Regular way purchase and sale transactions are recognised using either **trade date** accounting or **settlement date** accounting for financial assets.

2.1 Introduction

When an entity first recognises a financial asset or financial liability, it must classify it into an appropriate category. This classification determines how the financial instrument will be subsequently measured.

A financial asset or financial liability should be **derecognised**, that is removed, from an entity's statement of financial position, **when the entity ceases to be a party to the financial instrument's contractual provisions**.

2.2 IFRS 9 definitions

Before we look in more detail at recognition, classification and derecognition, here are the IFRS 9 definitions that are applicable.

Definitions

Financial asset: Any asset that is:

- cash;
- an equity instrument of another entity;
- a contractual right:
  - to receive cash or another financial asset from another entity; or
  - to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
- a contract that will or may be settled in the entity's own equity instruments and which is:
  - a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
  - a derivative that will or may be settled other than by exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

Financial liability: Any liability that is:

- a contractual obligation:
  - to deliver cash or another financial asset to another entity; or
  - to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
- a contract that will or may be settled in the entity's own equity instruments and which is:
  - a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
  - a derivative that will or may be settled other than by exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the

entity's own equity instruments.

Equity instrument: Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

2.3 Initial recognition and measurement

An entity will recognise a financial asset or financial liability on its statement of financial position **when it becomes a party to the contractual provisions of the instrument** rather than when the contract is settled. An important consequence of this is that all derivatives should be recognised in the statement of financial position. This is because even if there is no initial investment or the initial investment is relatively low, derivative contracts expose the entity to risks and rewards due to changes in value of the underlying. In most cases, the date on which an entity becomes a party to a financial instrument's contractual obligations is fairly obvious. For example, option contracts are recognised as assets or liabilities when the holder or writer becomes a party to the contract.

2.4 Classification of financial assets

2.4.1 Introduction

On recognition, IFRS 9 requires that financial assets are classified as measured at either:

- **amortised cost**;
- **fair value through other comprehensive income**; or
- **fair value through profit or loss**.

2.4.2 Basis of classification

The IFRS 9 classification is made on the basis of both:

(a) the **entity's business model** for managing the financial assets; and

(b) the **contractual cash flow** characteristics of the financial asset.

Amortised cost

A financial asset is classified as measured at **amortised cost** where:

(a) the objective of the business model within which the asset is held is to hold assets in order to collect contractual cash flows; and

(b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding.

Fair value through other comprehensive income

A debt instrument **must** be classified and measured **at fair value through other comprehensive income** (unless the asset is designated at fair value through profit or loss under the fair value option) if it meets both the following criteria:

(a) The financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.

(b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

Fair value through profit or loss

All other debt instruments must be measured at **fair value through profit or loss.** **Fair value through profit or loss option to avoid an 'accounting mismatch'**

Even if an instrument meets the above criteria for measurement at amortised cost or fair value through other comprehensive income, IFRS 9 allows such financial assets to be **designated, at initial recognition, as being measured at fair value through profit or loss. This concession is limited to cases where a recognition or measurement inconsistency** (an 'accounting mismatch') would **otherwise arise** from measuring assets or liabilities or recognising the gains and losses on them on different bases.

Equity instruments

Equity instruments may not be classified as measured at amortised cost and must be measured at fair value. This is because contractual cash flows on specified dates are not a characteristic of equity instruments. However, if an equity instrument is **not held for trading**, an entity can make an **irrevocable election** at initial recognition to measure it at **fair value through other comprehensive income** with only dividend income recognised in profit or loss.

This is **different from the treatment of debt instruments**, where the **fair value through other comprehensive income classification is mandatory** for assets meeting the criteria, unless the fair value through profit or loss option is chosen.

(IFRS 9.4.1.1–.4.1.2)

Professional skills focus: Applying judgement

IFRS 9 is very specific about how instruments may be classified, which means there is limited scope for judgement. However, entities have a choice about the irrevocable FVTOCI election for equity instruments not held for trading.

2.4.3 Business model test in more detail

IFRS 9 contains a business model test that requires an entity to assess whether its **business objective for a debt instrument is to collect the contractual cash flows of the instrument as opposed to realising its fair value change from sale prior to its contractual maturity**. Note the following key points:

(a) The assessment of a 'business model' is not made at an individual financial instrument level.

(b) The assessment is based on how key management personnel actually manage the business, rather than management's intentions for specific financial assets.

(c) An entity may have more than one business model for managing its financial assets and the classification need not be determined at the reporting entity level. For example, it may have one portfolio of investments that it manages with the objective of collecting contractual cash flows and another portfolio of investments held with the objective of trading to realise changes in fair value. It would be appropriate for entities like these to carry out the assessment for classification purposes at portfolio level, rather than at entity level.

(d) Although the objective of an entity's business model may be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those assets until maturity. Thus an entity's business model can be to hold financial assets to collect contractual cash flows even when sales of financial assets occur.

The following examples, from the Application Guidance to IFRS 9 (IFRS 9: AG, B4.1.1–B4.1.26), are of situations where the **objective of an entity's business model may be to hold financial assets to collect the contractual cash flows.**

Context example: Collecting contractual cash flows 1

A Co holds investments to collect their contractual cash flows but would sell an investment in particular circumstances, perhaps to fund capital expenditure, or because the credit rating of the instrument falls below that required by A Co's investment policy.

Although A Co may consider, among other information, the financial assets' fair values from a liquidity perspective (ie, the cash amount that would be realised if A Co needs to sell assets), A Co's objective is to hold the financial assets and collect the contractual cash flows. Some sales would not contradict that objective. If sales became frequent, A Co might be required to reconsider whether the sales were consistent with an objective of collecting contractual cash flows.

Context example: Collecting contractual cash flows 2

B Co has a business model with the objective of originating loans to customers and subsequently to sell those loans to a securitisation vehicle. The securitisation vehicle issues instruments to investors.

B Co, the originating entity, controls the securitisation vehicle and thus consolidates it. The securitisation vehicle collects the contractual cash flows from the loans and passes them on to its investors in the vehicle.

It is assumed for the purposes of this example that the loans continue to be recognised in the consolidated statement of financial position because they are not derecognised by the securitisation vehicle.

The consolidated group originated the loans with the objective of holding them to collect the contractual cash flows.

However, B Co has an objective of realising cash flows on the loan portfolio by selling the loans to the securitisation vehicle, so for the purposes of its separate financial statements it would not be considered to be managing this portfolio in order to collect the contractual cash flows.

Context example: Collecting contractual cash flows 3

C Co's business model is to purchase portfolios of financial assets, such as loans. Those portfolios may or may not include financial assets that are credit impaired. If payment on the loans is not made on a timely basis, C Co attempts to extract the contractual cash flows through various means – for example, by contacting the debtor through mail, telephone, and so on.

In some cases, C Co enters into interest rate swaps to change the interest rate on particular financial assets in a portfolio from a floating interest rate to a fixed interest rate.

The objective of C Co's business model is to hold the financial assets and collect the contractual cash flows. The entity does not purchase the portfolio to make a profit by selling them.

The same analysis would apply even if C Co does not expect to receive all of the contractual cash flows (eg, some of the financial assets are credit impaired at initial recognition).

Moreover, the fact that C Co has entered into derivatives to modify the cash flows of the portfolio does not in itself change C Co's business model.

2.4.4 Contractual cash flow test in more detail

The requirement in IFRS 9 to assess the contractual cash flow characteristics of a financial asset is based on the concept that **only instruments with contractual cash flows of principal and interest on principal may qualify for amortised cost measurement**. By interest, IFRS 9 means consideration for the time value of money and the credit risk associated with the principal outstanding during a particular period of time.

Measurement at amortised cost is permitted when the cash flows on a loan are entirely fixed (eg, a fixed interest rate loan or zero coupon bond), or where interest is floating (eg, a GBP loan where interest is contractually linked to GBP SONIA), or combination of fixed and floating (eg, where interest is SONIA plus a fixed spread). Note that SONIA, Sterling Overnight Index Average is a benchmark rate that replaced LIBOR in 2021.

2.4.5 Examples of instruments that pass the contractual cash flows test

The following instruments satisfy the IFRS 9 criteria.

(a) A variable rate instrument with a stated maturity date that permits the borrower to choose to pay three-month SONIA for a three-month term or one-month SONIA for a one-month term

(b) A fixed term variable market interest rate bond where the variable interest rate is capped

(c) A fixed term bond where the payments of principal and interest are linked to an unleveraged inflation index of the currency in which the instrument is issued

2.4.6 Examples of instruments that do not pass the contractual cash flows test

The following instruments do not satisfy the IFRS 9 criteria:

- A bond that is convertible into equity instruments of the issuer
- A loan that pays an inverse floating interest rate (eg, 8% minus SONIA)

2.4.7 Business model of both collecting contractual cash flows and selling financial assets

The following examples, from the Application Guidance to IFRS 9 (IFRS 9: AG, B4.1.1 – B4.1.26), are of situations where the **objective of an entity's business model is achieved by both collecting contractual cash flows and selling financial assets**.

Context example: Both collecting contractual cash flows and selling financial assets 1

D Co expects to incur capital expenditure in a few years' time. D Co invests its excess cash in short and long-term financial assets so that it can fund the expenditure when the need arises. Many of the financial assets have contractual lives that exceed D Co's anticipated investment period.

D Co will hold financial assets to collect the contractual cash flows and, when an opportunity arises, it will sell financial assets to re-invest the cash in financial assets with a higher return.

The remuneration of the managers responsible for the portfolio is based on the overall return generated by the portfolio.

The objective of the business model is achieved by **both collecting contractual cash flows and selling financial assets**. D Co decides on an ongoing basis whether collecting contractual cash flows or selling financial assets will maximise the return on the portfolio until the need arises for the invested cash.

Context example: Both collecting contractual cash flows and selling financial assets 2

Logan plc holds financial assets to meet its everyday liquidity needs. The company actively manages the return on the portfolio in order to minimise the costs of managing those liquidity needs. That return consists of collecting contractual payments, as well as gains and losses from the sale of financial assets.

To this end, Logan plc holds financial assets to collect contractual cash flows, and sells financial assets to reinvest in higher yielding financial assets or to better match the duration of its liabilities. In the past, this strategy has resulted in frequent sales activity and such sales have been significant in value. This activity is expected to continue in the future.

The objective of the business model is to maximise the return on the portfolio to meet everyday liquidity needs and Logan plc achieves that objective by **both collecting contractual cash flows and selling financial assets.** In other words, **both collecting contractual cash flows and selling financial assets are integral** to achieving the business model's objective.

Interactive question 4: Contractual cash flows and selling financial assets

E Co expects to pay a cash outflow in 10 years to fund capital expenditure and invests excess cash in short-term financial assets. When the investments mature, E Co reinvests the cash in new short-term financial assets. E Co maintains this strategy until the funds are needed, at which time E Co uses the proceeds from the maturing financial assets to fund the capital expenditure. Only sales that are insignificant in value occur before maturity (unless there is an increase in credit risk).

Requirement

How is the business model of E Co classified under IFRS 9? See **Answer** at the end of this chapter.

2.5 Classification of financial liabilities

On **recognition**, IFRS 9 requires that financial liabilities are **classified as measured** either:

(a) at **fair value through profit or loss**; or

(b) at **amortised cost**.

A financial liability is classified at fair value through profit or loss if:

(a) it is **held for trading**; or

(b) upon initial recognition it is **designated at fair value through profit or loss**. This is permitted when it results in more relevant information because:

(1) it eliminates or significantly reduces a measurement or recognition inconsistency ('accounting mismatch'); or

(2) it is a group of financial liabilities or financial assets and liabilities and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy.

Derivatives are always measured at fair value through profit or loss.

2.6 Reclassification of financial assets

IFRS 9 requires that when an entity changes its business model for managing financial assets, it should reclassify all affected financial assets. This is expected to be a rare event.

A change in an entity's business model will occur only when an entity begins or ceases to perform an activity that is significant to its operations – for example, when the entity has acquired, disposed of or terminated a business line.

The examples of **change in a business model** include the following:

- An entity has a portfolio of commercial loans that it holds to sell in the short term. The bank acquires an entity that manages commercial loans and has a business model that holds the loans in order to collect the contractual cash flows. The portfolio of commercial loans is no longer for sale, and the portfolio is now managed together with the acquired commercial loans and all are held to collect contractual cash flows.
- An entity decides to shut down its retail mortgage business. That business no longer accepts new business and the bank is actively marketing its mortgage loan portfolio for sale.

If an entity reclassifies financial assets, the **reclassification is applied prospectively** from the first day of the first reporting period following the change in business model (**the reclassification date**).

The impact of reclassification of financial assets is as follows:

Asset category	Reclassified to:	Impact of reclassification
Amortised cost	Fair value through profit or loss	• Fair value is measured at the date of reclassification • Difference between amortised cost and fair value is recognised in profit or loss
Amortised cost	Fair value through other comprehensive income	• Fair value is measured at the date of reclassification • Difference between amortised cost and fair value is recognised in other comprehensive income
Fair value through other comprehensive income	Fair value through profit or loss	• Continue to measure at fair value • Cumulative gain or loss in other comprehensive income is reclassified to profit or loss at the reclassification date
Fair value through other comprehensive income	Amortised cost	• Fair value at the reclassification date is the new gross carrying amount • Cumulative gain or loss is removed from other comprehensive income (removed from equity and adjusted against fair value at the reclassification date but is not a reclassification adjustment hence does not affect profit or loss)
Fair value through profit or loss	Fair value through other comprehensive income	• Continue to measure at fair value • Subsequent gains and losses are recognised in OCI
Fair value through profit or loss	Amortised cost	• Fair value at the reclassification date is the new gross carrying amount • Effective interest rate is determined on the basis of the fair value at the reclassification date

Reclassification is not permitted for derivatives, financial liabilities and equity investments that are designated as at fair value through other comprehensive income on initial recognition.

When financial instruments are reclassified, disclosures are required under IFRS 7.

2.7 Derecognition of financial assets

2.7.1 Criteria for derecognition

Derecognition is the removal of a previously recognised financial instrument from an entity's statement of financial position.

An entity should derecognise a **financial asset** when:

(a) the **contractual rights** to the cash flows from the financial asset **expire;** or

(b) the entity **transfers substantially all the risks and rewards of ownership** of the financial asset to another party.

Derecognition of a financial asset is often straightforward, as the above criteria can be implemented easily. For example, a bond should be derecognised when an entity has collected all the payments of coupon and principal amount – ie, the bond has matured. The collection of payment signifies the end of any exposure to risks or any continuing involvement.

There may, however, be more complex transactions which involve the transfer of legal title to another entity but only a partial transfer of risks and rewards. In such instances, further analysis is required to evaluate whether the asset should be fully derecognised, and whether a separate asset or liability recognised, to reflect the remaining rights or obligations.

2.7.2 Accounting treatment

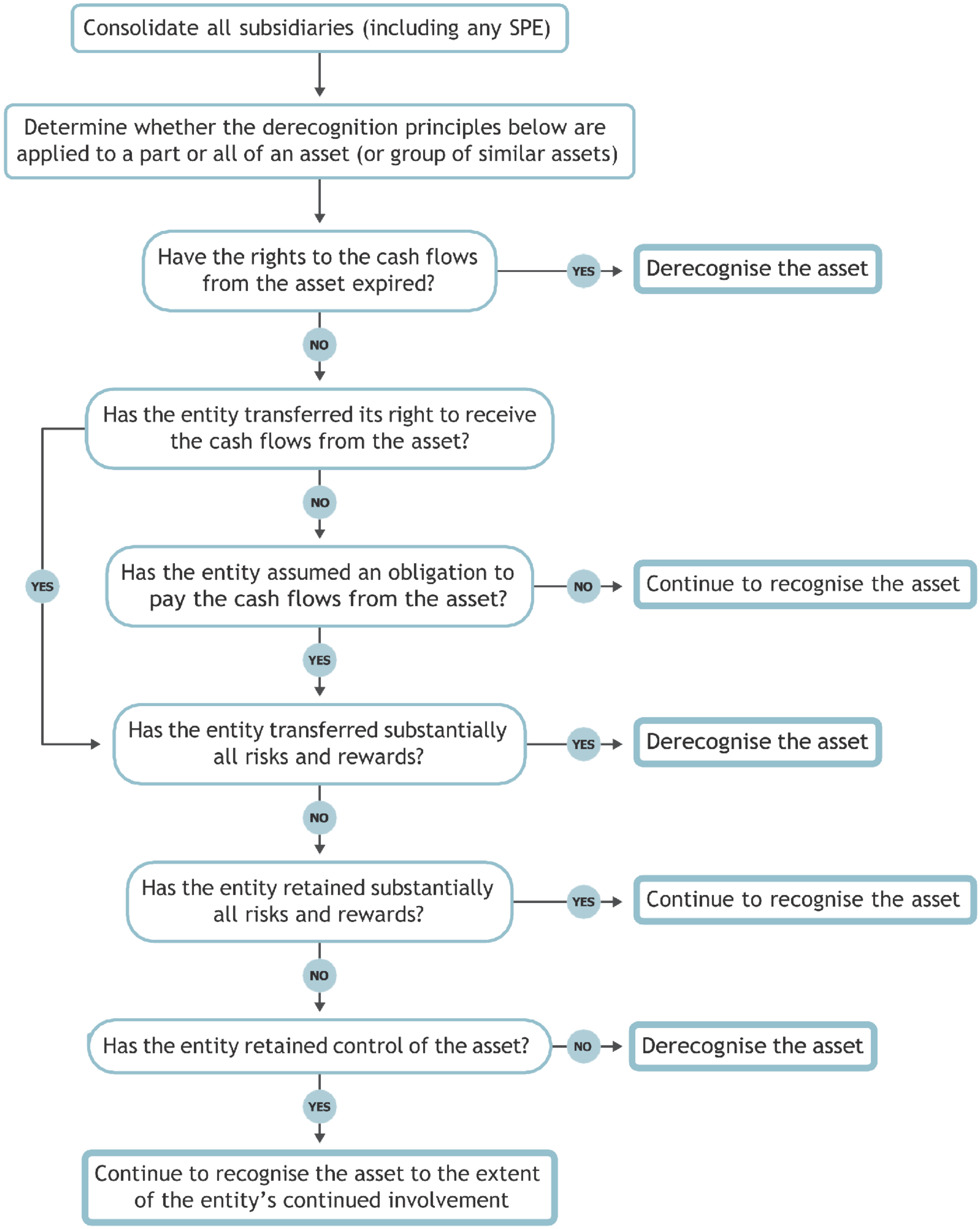
On derecognition of a financial asset the difference between the **carrying amount and any consideration received should be recognised in profit or loss**. For investments in debt instruments that are measured at fair value through other comprehensive income, any accumulated gains or losses that have been recognised in other comprehensive income should be reclassified to profit or loss on derecognition of the asset.

2.7.3 The IFRS 9 derecognition steps

The complexity of financial transactions and the difficulty of establishing whether the transfer of legal title leaves residual risk and reward exposures as well as control and involvement, has prompted the IASB to produce a fairly prescriptive set of rules to aid companies in the derecognition of financial assets.

The following flowchart, included in the application guidance which accompanies IFRS 9 (IFRS 9: Application Guidance, Appendix B, 3.2.1), summarises the evaluation of whether, and to what extent, a financial asset should be derecognised.

Figure 16.1: Derecognition of financial assets (IFRS 9.B3.2.1) The following points relate to this flowchart:



- If the **contractual rights** to receive the cash flows from the asset have **expired** or have been wholly transferred, the whole of the asset should be derecognised. This is also the case if the contractual rights have been retained by the entity but it has assumed a contractual obligation to pay the cash flows to one or more recipients. Such an obligation is only assumed if:

- there is no obligation to pay unless amounts are actually collected;
- the entity is forbidden to sell or pledge the original asset other than to the recipient of the cash flows; and
- the entity must remit the cash flows collected, including any interest earned during temporary investment between the date of collection to date of remittance, without material delay.

- If an entity has sold just a portion of the cash flows arising from an asset, only part of the asset should be derecognised.
- If substantially **all the risks and rewards** of ownership have been **transferred**, the financial asset should be derecognised and separate assets or liabilities should be recognised for any rights or obligations created in the transfer.
- If the entity has neither retained nor transferred all the risks and rewards of ownership, it should determine whether it has **retained control** of the financial asset. If it has, it continues to recognise the asset to the extent of its continuing involvement.

Repurchase agreements may be employed in order to try to remove assets from the statement of financial position.

Remember always to apply the principle of substance over legal form.

2.7.4 Repurchase agreements

In a repurchase agreement, a financial asset such as a bond is sold with a simultaneous agreement to buy it back at some future date at a specified price, which may be the future market price.

Worked example: Repurchase agreements

1 Green Co sells a bond carried on its statement of financial position to Red Co for £1,000. Green Co commits to buy back the bond in three months for £1,025.

Has Green Co transferred substantially all the risks and rewards of ownership?

2 Would your answer be different if Green Co commits to buyback in three months at market price?

Solution

1 IFRS 9 includes examples with regard to these situations:

This is a sale and repurchase transaction where the repurchase price is a fixed price or at the sale price plus a lender's return. Green Co has not transferred substantially all the risks and rewards of ownership and hence the bond is not derecognised. Green Co will recognise a loan liability of £1,000 and interest expense of £25 to reflect the collateralised borrowing.

2 This is a sale of a financial asset together with commitment to repurchase the financial asset at its fair value at the time of repurchase. Because any repurchase is at the then fair value, all risks and rewards of ownership are with the buying party and hence Green Co will derecognise the bond.

2.8 Derecognition of financial liabilities

An entity should derecognise a **financial liability** when it is **extinguished** ie, when the obligation specified in the contract is discharged or cancelled or expires.

- An entity **discharges** its obligation by paying in cash, other financial assets or by delivering other goods or services to the counterparty.

- An obligation may **expire** due to passage of time as, for example, an unexercised written option.
- An obligation is **cancelled** when through the process of law, or via negotiation with a creditor, an entity is released from its primary obligation to pay the creditor.

When a liability is extinguished, the difference between its carrying amount and the consideration paid including any non-cash assets transferred and any new liabilities assumed is recognised in profit or loss.

Context example: Extinguishing a financial liability

Entity A has borrowed £10 million from a bank to invest in commercial development. However, due to a recession, the shops built did not yield the expected rental income and Entity A cannot service the debt. It negotiates with the bank to transfer the ownership of the development to the bank in settlement of the outstanding debt. The market value of the development is £7 million. The development's carrying amount was £7 million as it was measured at fair value.

As a result of the transfer, Entity A should extinguish the liability but it should also recognise a gain of £3 million in profit or loss, arising from the difference between the carrying amount of the liability (£10 million) and the value of the development (£7 million) that was transferred to the bank.

2.9 Partial derecognition of financial assets and financial liabilities

It is possible for only **part** of a financial asset or liability to be derecognised. This is the case if the part comprises:

(a) only specifically identified cash flows; or

(b) only a fully proportionate (pro rata) share of the total cash flows.

For example, if an entity holds a bond, it has the right to two separate sets of cash inflows: those relating to the principal and those relating to the interest. It could sell the right to receive the interest to another party while retaining the right to receive the principal.

On **derecognition**, the amount to be **included in profit or loss** for the year is calculated as follows:

	£
Carrying amount (measured at the date of derecognition) allocated to the part derecognised	X
Less consideration received for the part derecognised (including any new asset obtained less any new liability assumed)	(X)
Difference to profit or loss	X

Where only part of a financial asset is derecognised, the carrying amount of the asset should be allocated between the part retained and the part transferred based on their relative fair values on the date of transfer. A gain or loss should be recognised based on the proceeds for the portion transferred.

Worked example: Partial derecognition

Westerly plc purchased £100,000 of bonds which were classified as designated at fair value through profit or loss. One year later, 25% of the bonds were sold for £37,500. Total cumulative gains previously recognised in profit or loss in respect of the asset were £6,250.

Requirement

In accordance with IFRS 9, *Financial Instruments*, what is the amount of the gain on the disposal to be recognised in profit or loss?

Solution

When a part of a financial asset is derecognised, the amount recognised in profit or loss should be the difference between the carrying amount allocated to the part derecognised and the sum of:

(1) the consideration received for the part derecognised; and an

(2) any cumulative gain or loss allocated to it that had been recognised in other comprehensive income.

The previous gains had been recognised in profit or loss and so are not included in the calculation.

	£
Carrying amount of the assets sold/derecognised (25% of £106,250)	26,562.50
Proceeds from sale of 25% of bonds	37,500.00
Gain recognised in the period of sale	10,937.50

Interactive question 5: Sale of cash flows from debt instrument

During the year ended 31 December 20X0, Jones sold to a third party the right to receive the interest cash flows on a fixed maturity debt instrument it holds and will continue to legally own up to the date of maturity. The debt instrument is quoted in an active stock market. The entity has no obligation to compensate the third party for any cash flows not received.

Requirement

Discuss whether the debt instrument should be derecognised. See **Answer** at the end of this chapter.

Interactive question 6: Derecognition of financial assets and liabilities

Discuss whether the following financial instruments should be derecognised.

6.1 ABC sells an investment in shares, but retains a call option to repurchase those shares at any time at a price equal to their current market value at the date of repurchase.

6.2 DEF enters into a stock lending agreement where an investment is lent to a third party for a fixed period of time for a fee.

6.3 XYZ sells title to some of its receivables to a debt factor for an immediate cash payment of 90% of their value. The terms of the agreement are that XYZ has to compensate the factor for any amounts not recovered by the factor after six months.

See **Answer** at the end of this chapter.

2.10 Exchange or modification of debt

If a new loan is agreed between a borrower and a lender, or the two parties agree revised terms for an existing loan, the accounting depends on whether the original liability should be derecognised and a new liability recognised, or whether the original liability should be treated as modified.

A new liability should be recognised if the new terms are substantially different from the old terms. The terms are substantially different if the present value of the cash flows under the new terms, including any fees payable/receivable, discounted at the original effective interest rate, is 10% or more different from the present value of the remaining cash flows under the original terms. There is said to be an 'extinguishment' of the old liability. In these circumstances:

- the difference between the carrying amount extinguished and the consideration paid should be recognised in profit or loss; and
- the fees payable/receivable should be recognised as part of that gain or loss.

If the difference between the two present values is below this cut-off point, there is said to be a modification of the terms. In these circumstances:

- the existing liability is **not** derecognised; and
- its carrying amount is adjusted by the fees payable/receivable and amortised over the remaining term of the modified liability.

Worked example: Modification of debt

On 1 May 20X4 Delta plc issues £10 million 10% loan stock redeemable at par after 10 years. Interest is paid annually in arrears. On 1 May 20X9, Delta plc and the loan stockholders agree to a modification with the following terms:

- No further interest payments are made
- The loan stock is redeemed on the original date for £17 million

Legal and other fees relating to the modification amount to £500,000. Assume the borrowing cost of Delta has not changed over the years.

Requirement

How is this modification accounted for by Delta plc?

Solution

The present value of remaining cash flows is compared with the present value of cash flows under the new terms.

The present value of the cash flows arising on the old terms is £10 million:

	£
Interest 30.4.Y0 (£1m/1.1)	909,091
Interest 30.4.Y1 (£1m/1.1^2)	826,446
Interest 30.4.Y2 (£1m/1.1^3)	751,315
Interest 30.4.Y3 (£1m/1.1^4)	683,013
Interest and principal 30.4.Y4 (£11m/1.1^5)	6,830,135
	10,000,000

The present value of cash flows arising after the modification is £11,055,662:

	£
Principal (£17m/1.1^5)	10,555,662
Fees incurred	500,000
	11,055,662

The increase in cash flows represents more than a 10% change from £10 million. Therefore the original financial liability is derecognised and a new financial liability on the new terms is recognised. The new financial liability is initially measured at fair value in accordance with IFRS 9 and any difference between this amount and the derecognised financial liability is recognised in profit or loss.

2.11 Regular way transactions

Note: As regards purchases, this issue relates to recognition rather than derecognition; however, it was necessary to understand the classification aspects in detail before studying this section.

Most financial markets set out regulations for 'regular way' transactions whereby purchases and sales are contractually deliverable (and therefore settled) on a specified date. Settlement date is later than the contractual date of the transaction (the 'trade date'). A regular way purchase or sale is the acquisition or disposal of a financial asset under a contract requiring delivery within a **specified time frame**. The time frame may be established through regulation or convention in the market.

Regular way purchases and sales of financial instruments should be recognised using either the **trade date** or the **settlement date**. The method chosen should be applied consistently for all financial assets. A derivative contract is not a regular way contract, since it can be settled on a net basis.

For purchases, **trade date accounting** requires the recognition of an asset and the liability to pay for it at the trade date. After initial recognition, the financial asset is subsequently measured either at amortised cost or at fair value, depending on its initial classification. For sales of financial assets, the asset is derecognised and the receivable from the buyer, together with any gain or loss on disposal, are recognised on the trade date.

With **settlement date accounting**, an asset purchased is not recognised until the date on which it is received. Movements in fair value of the contract between the trade date and settlement date are recognised in the same way as the acquired asset. For assets classified as assets at fair value through profit or loss, the change is recognised in profit or loss. For assets classified at fair value through other comprehensive income, the change is recognised in other comprehensive income.

For sales of financial instruments, the asset is derecognised and the receivable from the buyer, together with any gain or loss on disposal, are recognised on the day that it is delivered by the entity. Any change in the fair value of the asset between the trade date and settlement date is not recognised, as the sale price is agreed at the trade date, making subsequent changes in fair value irrelevant from the seller's perspective.

Worked example: Regular way purchase of a financial asset

IDB Bank entered into a contractual commitment on 27 December 20X8 to purchase a financial asset for £2,500. On 31 December 20X8, the bank's reporting date, the fair value was £2,513. The transaction was settled on 5 January 20X9 when the fair value was £2,519. The bank has classified the asset at fair value through profit or loss.

Requirement

How should the transactions be accounted for under trade date accounting and settlement date accounting?

Solution

Trade date accounting

- On 27 December 20X8, the bank should recognise the financial asset and the liability to the counterparty at £2,500.
- At 31 December 20X8, the financial asset should be re-measured to £2,513 and a gain of £13 recognised in profit or loss.
- On 5 January 20X9, the liability to the counterparty of £2,500 will be paid in cash. The fair value of the financial asset should be re-measured to £2,519 and a further gain of £6 recognised in profit or loss.

Settlement date accounting

- No transaction should be recognised on 27 December 20X8.
- On 31 December 20X8, a receivable of £13 should be recognised (equal to the fair value movement since the trade date) and the gain recognised in profit or loss.
- On 5 January 20X9, the financial asset should be recognised at its fair value of £2,519. The receivable should be derecognised, the payment of cash to the counterparty recognised and the further gain of £6 recognised in profit or loss.

Interactive question 7: Regular way sale of a financial asset

High Growth Bank acquired a financial asset on 1 January 20X8 for £3,000. On 27 December 20X8, it entered into a contract to sell the asset for £3,250. On 31 December 20X8, the bank's reporting date, the fair value of the asset was £3,293. The transaction was settled on 5 January 20X9. The bank classified the asset as at fair value through other comprehensive income.

Requirement

How should the transactions be accounted for under trade date accounting and settlement date accounting?

See **Answer** at the end of this chapter.

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3 Measurement

Section overview

- **Financial assets** should initially be measured at **cost** = **fair value**.
- **Transaction costs increase this amount for financial assets** classified as measured at amortised cost, or where an irrevocable election has been made to take all gains and losses through other comprehensive income and **decrease this amount for financial liabilities** classified as measured at amortised cost.
- **Subsequent measurement** of both financial assets and financial liabilities depends on how the instrument is classified: at amortised cost or fair value.

3.1 Initial measurement: financial assets

Financial instruments are initially measured at the transaction price, that is the **fair value** of the consideration given (IFRS 9.5.1.1).

An **exception** is where part of the consideration given is for something other than the financial asset. In this case, the financial asset is initially measured at fair value evidenced by a quoted price in an active market for an identical asset (ie, an IFRS 13 level 1 input) or based on a valuation technique that uses only data from observable markets. The difference between the fair value at initial recognition and the transaction price is recognised as a gain or loss.

In the case of financial assets classified as measured at **amortised cost or at fair value through other comprehensive income**, **transaction costs** directly attributable to the acquisition of the financial asset are **added** to this amount.

3.2 Initial measurement: financial liabilities

IFRS 9 requires that financial liabilities are initially measured at transaction price, i.e., the fair value of consideration received except where part of the consideration received is for something other than the financial liability. In this case the financial liability is initially measured at fair value measured as for financial assets (see above). Transaction costs are deducted from this amount for financial liabilities classified as measured at amortised cost (IFRS 9:Para. 5.1.1).

3.3 Subsequent measurement: financial assets

Under IFRS 9, financial assets are measured subsequent to recognition either:

- at **amortised cost**, using the **effective interest method**, or
- at **fair value through other comprehensive income**, or
- at **fair value through profit or loss**.

(IFRS 9.5.2.1)

3.4 Financial assets measured at amortised cost

Definitions

Amortised cost: The amount at which the financial asset or liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance.

Effective interest method: A method of calculating the amortised cost of a financial instrument and of allocating the interest income or interest expense over the relevant period.

Worked example: Financial asset at amortised cost

On 1 January 20X4, Beta plc purchases a debt instrument for its fair value of £1,000. The debt instrument is due to mature on 31 December 20X8. The instrument has a principal amount of £1,250 and carries fixed interest at 4.72% that is paid annually. (The effective interest rate is 10%.)

Requirement

How should Beta plc account for the debt instrument over its five-year term?

Solution

Beta plc will receive interest of £59 (1,250 × 4.72%) each year and £1,250 when the instrument matures.

Beta must allocate the discount of £250 and the interest receivable over the five-year term at a constant rate on the carrying amount of the debt. To do this, it must apply the effective interest rate of 10%.

The following table shows the allocation over the years:

Year	Amortised cost at beginning of year	Profit or loss: Interest income for year (@10%)	Interest received during year (cash inflow)	Amortised cost at end of year
	£	£	£	£
20X4	1,000	100	(59)	1,041
20X5	1,041	104	(59)	1,086
20X6	1,086	109	(59)	1,136
20X7	1,136	113	(59)	1,190
20X8	1,190	119	(1,250 + 59)	-

Each year the carrying amount of the financial asset is increased by the interest income for the year and reduced by the interest actually received during the year.

3.5 Financial assets measured at fair value

Where a financial asset is classified as measured at fair value, fair value is established at each period end in accordance with IFRS 13, *Fair Value Measurement*.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

IFRS 13 provides extensive guidance on how the fair value of assets and liabilities should be established.

This standard requires that the following are considered in determining fair value:

(a) The asset or liability being measured

(b) The principal market (ie, that where the most activity takes place) or where there is no principal market, the most advantageous market (ie, that in which the best price could be achieved) in which an orderly transaction would take place for the asset or liability

(c) The highest and best use of the asset or liability, and whether it is used on a standalone basis or in conjunction with other assets or liabilities

(d) Assumptions that market participants would use when pricing the asset or liability

Having considered these factors, IFRS 13 provides a hierarchy of inputs for arriving at fair value. It requires that Level 1 inputs are used where possible:

Level 1: Quoted prices in active markets for identical assets that the entity can access at the measurement date

Level 2: Inputs other than quoted prices that are directly or indirectly observable for the asset

Level 3: Unobservable inputs for the asset

If an entity has investments in **equity instruments that do not have a quoted price** in an active market, they should also be measured at fair value. IFRS 13 should be applied, for example the market approach, using prices and other relevant information that have been generated by market transactions that involve identical or comparable assets (IFRS 13 para B5).

The fair value on initial recognition is normally the transaction price. However, if part of the consideration is given for something other than the financial instrument, then the fair value should be estimated using a valuation technique.

Any changes in fair value are normally recognised in profit or loss. There are three **exceptions** to this rule:

(a) The asset is **part of a hedging relationship** (see next Chapter).

(b) The financial asset is an investment in an **equity instrument not held for trading**. In this case, the entity can make an **irrevocable election** to recognise changes in the fair value in **other comprehensive income**.

(c) It is a **financial asset measured at fair value through other comprehensive income** because it meets the criteria above, that is the financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.

Note that direct costs of acquisition are capitalised only in the case of a financial asset or financial liability **not** held at fair value through profit or loss. If the asset or liability is held at fair value through profit or loss, the costs of acquisition are expensed. This means that in the case of **financial assets held at amortised cost, costs of acquisition are capitalised.** They would be added to the asset and deducted from the liability amount. Similarly, if an **irrevocable election** has been made to take **gains and losses** on the financial asset **to other comprehensive income**, costs of acquisition should be **added to the purchase cost.**

Investments whose **fair value cannot be reliably measured** should be measured at cost.

Worked example: Asset measurement

On 8 February 20X8, Orange Co acquires a quoted investment in the shares of Lemon Co with the intention of holding it in the long term. The investment cost £850,000. At Orange Co's year end of 31 March 20X8, the market price of an identical investment is £900,000.

Requirement

How is the asset initially and subsequently measured?

Orange Co has elected to recognise changes in the fair value of the equity investment in other comprehensive income.

Solution **Measurement**

- The asset is initially recognised at the fair value of the consideration, being £850,000.
- At the period end it is re-measured to £900,000.
- This results in the recognition of £50,000 in other comprehensive income.

Interactive question 8: Investment in listed shares

In January 20X6 Wolf purchased 10 million £1 listed equity shares in Hall at a price of £5 per share. Transaction costs were £3 million. Wolf's year end is 30 November.

At 30 November 20X6, the shares in Hall were trading at £6.50. On 31 October 20X6 Wolf received a dividend from Hall of 20p per share.

Requirements

Show the financial statement extracts of Wolf at 30 November 20X6 relating to the investment in Hall on the basis that:

(a) the shares were bought for trading;

(b) the shares were bought as a source of dividend income and were the subject of an irrevocable election at initial recognition to recognise them at fair value through other comprehensive income; and

(c) the shares were bought as a source of dividend income and were the subject of an irrevocable election at initial recognition to recognise them at fair value through other comprehensive income. However, on 1 June 20X6, Wolf sold half of its shareholding in Hall when the shares were trading at £6.

See **Answer** at the end of this chapter.

3.6 Summary of measurement rules

The following table summarises the IFRS 9 measurement rules. It is a useful reference point for your exam.

	Amortised cost	Fair value through other comprehensive income: equity instrument	Fair value through other comprehensive income: debt instrument	Fair value through profit or loss
Interest/ dividend income	Profit or loss	Profit or loss	Profit or loss	Profit or loss
Expected credit losses (see section 4)	Profit or loss	Profit or loss	Profit or loss	Profit or loss
Foreign exchange gains/losses	Profit or loss	Profit or loss	Profit or loss	Profit or loss
Other gains/losses on remeasurement	–	Other comprehensive income	Other comprehensive income	Profit or loss
Gain/loss on derecognition	Profit or loss	Profit or loss but OCI is not reclassified*	Profit or loss Amounts previously recognised in OCI are reclassified to profit or loss	Profit or loss

Note: *While the gain/loss on derecognition of an equity instrument at FVTOCI is recognised in profit or loss, in practice this should normally be a nil amount, assuming the disposal is at fair value. The asset's carrying amount is remeasured to fair value at the date of derecognition (IFRS 9: para. 3.2.12) immediately prior to the disposal. Any change resulting from such a remeasurement is recognised in OCI.

Worked example: Debt instrument at fair value through other comprehensive income

On 1 January 20X1 Gemma plc purchases a quoted debt instrument for its fair value of £1,000. The debt instrument is due to mature on 31 December 20X5 and the entity has the intention to hold the debt instrument until that date in order to collect contractual cash flows. The instrument has a principal amount of £1,250 and carries fixed interest at 4.72% that is paid annually. (The effective interest rate is 10%.)

Gemma plc holds the debt instrument within a business model with the intention of collecting contractual cash flows and selling assets. The fair value of the debt instrument is £1,210 at 31 December 20X1, £1,340 at 31 December 20X2, £1,400 at 31 December 20X3 and £1,445 at 31 December 20X4.

Requirements

1 How should Gemma plc account for the debt instrument over its five-year term?

2 How should Gemma plc account for the debt instrument on derecognition?

Solution

1 The financial asset is classified as measured at fair value through other comprehensive income since it is held within a business model to collect contractual cash flows and sell assets. It gives rise to contractual cash flows on specified dates that are solely payments of principal and interest on the principal outstanding.

The following table shows the measurement over the term.

Year	Carrying amount b/f	Profit or loss: Interest income for year (@ 10%)	Interest and/or principal received during year (cash inflow)	Gain or loss on remeasurement to fair value/ derecognition	Fair value
		£	£	£	£
20X1	1,000	100	(59)	169	1,210
20X2	1,210	104	(59)	85	1,340
20X3	1,340	109	(59)	10	1,400
20X4	1,400	113	(59)	(9)	1,445
20X5	1,445	119	(1,309)	(255)	0

Note that interest income is calculated based on amortised cost and interest received is calculated based on the principal amount.

The required journal entries in 20X1 are:

		£
DEBIT	Financial asset through other comprehensive income	1,000
CREDIT	Cash/bank	1,000

To recognise the financial asset on 1 January 20X1

		£
DEBIT	Financial asset through other comprehensive income	210
DEBIT	Cash/bank	59
CREDIT	Profit or loss (interest income)	100
CREDIT	Other comprehensive income	169

To recognise interest income at the effective rate and the change in fair value.

2 On derecognition of a debt instrument measured at fair value through other comprehensive income, any amounts previously recognised as other comprehensive income are reclassified to profit or loss. Note that this is different from equity instruments held at FVTOCI, where gains and losses previously recognised through OCI are not reclassified.

Therefore in the example above, a loss of £255 is recognised in profit or loss on derecognition:

DEBIT	Profit or loss	£255
CREDIT	Financial asset	£255

And a cumulative net gain of £255 (169 + 85 + 10 – 9) is reclassified by:

DEBIT	Other comprehensive income	£255
CREDIT	Profit or loss	£255

3.7 Subsequent measurement of financial liabilities

After initial recognition, all financial liabilities should be measured at **amortised cost**, with the exception of financial liabilities at fair value through profit or loss (including most derivatives). These should be measured at **fair value**, but where the fair value **is not capable of reliable measurement**, they should be measured at **cost** (IFRS 9.5.3.1).

3.8 Financial liabilities measured at amortised cost

The definitions of amortised cost, effective interest method and effective interest rate that are used for measurement of financial assets are also used for financial liabilities.

Worked example: Liability measurement

Galaxy Co issues a bond for £503,778 on 1 January 20X2. No interest is payable on the bond, but it will be redeemed on 31 December 20X4 for £600,000. The effective interest rate of the bond is 6%.

Requirement

Calculate the charge to profit or loss of Galaxy Co for the year ended 31 December 20X2 and the balance outstanding at 31 December 20X2.

Solution

The bond is a 'deep discount' bond and is a financial liability of Galaxy Co. It is measured at amortised cost. Although there is no interest as such, the difference between the initial cost of the bond and the price at which it will be redeemed is a finance cost. This must be allocated over the term of the bond at a constant rate on the carrying amount.

The effective interest rate is 6%.

The charge to profit or loss for the year is £30,227 (503,778 × 6%).

The balance outstanding at 31 December 20X2 is £534,004 (503,778 + 30,226).

Interactive question 9: Measurement of liability

On 1 January 20X3 Deferred issued £600,000 loan notes. Issue costs were £200. The loan notes do not carry interest, but are redeemable at a premium of £152,389 on 31 December 20X4. The effective finance cost of the loan notes is 12%.

Requirement

What is the finance cost in respect of the loan notes for the year ended 31 December 20X4?

A	£72,000
B	£76,194
C	£80,613
D	£80,640

See **Answer** at the end of this chapter.

3.9 Financial liabilities at fair value through profit or loss

Financial liabilities which are **held for trading** are re-measured to fair value each year in accordance with IFRS 13, *Fair Value Measurement* with any gain or loss recognised in profit or loss (IFRS 9.5.7.1).

3.9.1 Exceptions

The exceptions to the above treatment of financial liabilities are as follows:

(a) It is part of a hedging arrangement.

(b) It is a financial liability designated as at fair value through profit or loss and the entity is required to present the effects of changes in the liability's **credit risk** in other comprehensive income (see 3.9.2 below).

3.9.2 Credit risk

IFRS 9 requires that financial liabilities which are **designated as measured at fair value through profit or loss are treated differently**. In this case the gain or loss in a period must be classified into:

- gain or loss **resulting from credit risk**; and
- **other** gain or loss.

This provision of IFRS 9 was in response to an anomaly regarding changes in the credit risk of a financial liability.

Changes in a financial liability's credit risk affect the fair value of that financial liability. This means that when an entity's creditworthiness deteriorates, the fair value of its issued debt will decrease (and *vice versa*). For financial liabilities measured using the fair value option, this causes **a gain (or loss) to be recognised in profit or loss for the year**. For example:

Statement of profit or loss and other comprehensive income (extract) – Profit or loss for the year

	£'000
Liabilities at fair value (except derivatives and liabilities held for trading)	
Change in fair value	100
Profit (loss) for the year	100

Many users of financial statements found this result to be **counter-intuitive** and confusing. Accordingly, IFRS 9 requires the gain or loss as a result of credit risk to be recognised in other comprehensive income, unless it creates or enlarges an **accounting mismatch** (see 3.9.3), in which case it is recognised in profit or loss. The other gain or loss (not the result of credit risk) is recognised in profit or loss.

On derecognition any gains or losses recognised in other comprehensive income are **not** transferred to **profit or loss**, although the cumulative gain or loss may be transferred within equity.

Context example: IFRS 9 presentation

Statement of profit or loss and other comprehensive income (extract) Profit or loss for the year
Liabilities at fair value (except derivatives and liabilities held for trading)

£'000	
Change in fair value not attributable to credit risk	90
Profit (loss) for the year	90

Other comprehensive income (not reclassified to profit or loss)

	£'000
Fair value loss on financial liability attributable to change in credit risk	10
Total comprehensive income	100

3.9.3 Accounting mismatch

IFRS 9 allows the recognition of the full amount of change in the fair value in the profit or loss only if the recognition of changes in the liability's **credit risk** in other comprehensive income would **create** or **enlarge** an **accounting mismatch** in profit or loss. That determination is made at initial recognition and is not reassessed (IFRS 9.4.1.5).

An accounting mismatch is a measurement or recognition inconsistency arising from measuring assets or liabilities or recognising the gains or losses on them on different bases.

4 Credit losses (impairment)

Section overview

- This section covers the key points in the IFRS 9 expected credit loss impairment model.
- The previous standard, IAS 39, required an impairment loss to be recognised if and only if there was objective evidence of impairment. This approach was criticised after the Global Financial Crisis of 2007/08 as recognising impairments 'too little, too late'. IFRS 9 therefore requires the expected credit loss model to ensure timely recognition of credit losses.
- On initial recognition of the financial asset, an impairment allowance is recognised based on 12- month expected credit losses.
- If there is a significant increase in credit risk after initial recognition, impairment allowances are recognised based on lifetime expected credit losses (LEL).
- The general or three-stage approach requires the financial asset to be classified in Stage 1 on initial recognition. If there is a significant increase in credit risk, the asset is moved to Stage 2. On default the financial asset transfers to Stage 3. Interest revenue is calculated on the net carrying amount of the asset (after the deduction of the impairment allowance) in Stage 3.
- Assessment of a significant increase in credit risk may be based on quantitative indicators, qualitative indicators or a mixture of both. It requires the use of reasonable and supportable information available without undue cost or effort, including use of forward looking macro- economic data.

- If a financial asset is purchased or originated credit-impaired, expected credit losses shall be discounted using the credit-adjusted effective interest rate determined at initial recognition.
- Simplified approaches and practical expedients may be used by non-financial entities for operational simplification in applying the impairment model.

4.1 Indications of impairment

The following are indications that a financial asset or group of assets may be impaired (IFRS 9: Appendix A).

(a) Significant financial difficulty of the issuer

(b) A breach of contract, such as a default in interest or principal payments

(c) The lender granting a concession to the borrower that the lender would not otherwise consider, for reasons relating to the borrower's financial difficulty

(d) It becomes probable that the borrower will enter bankruptcy

(e) The disappearance of an active market for that financial asset because of financial difficulties

(f) The purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses

It is not always possible to single out one particular event; rather, several events may combine to cause an asset to become credit-impaired.

4.2 Background and scope of IFRS 9 impairment model

IFRS 9, *Financial Instruments* was published in response to an urgent need to improve the accounting for financial instruments. IFRS 9 requires an **expected credit loss** model to ensure earlier and **timely recognition of credit losses**. This has a significant impact on banks as both incurred and future expected credit losses are considered in the measurement of impairment. A single set of impairment requirements applies to all instruments within the scope of the new standard. Financial liabilities are not subject to impairment.

The following instruments are in the **scope of IFRS 9 impairment** requirements:

- Financial assets that are debt instruments measured at amortised cost or fair value through other comprehensive income
- Loan commitments and financial guarantee contracts not accounted for at fair value through profit or loss under IFRS 9
- Contract assets under IFRS 15, *Revenue from Contracts with Customers*
- Lease receivables under IFRS 16, *Leases*

All instruments measured at fair value through profit or loss are not required to be assessed for impairment because any fair value movements are automatically reflected in profit or loss.

4.3 IFRS 9 impairment model

4.3.1 Initial recognition of financial asset

An entity is required to create a **credit loss allowance/impairment allowance on initial recognition** of the financial asset. This is calculated by multiplying the probability of a default occurring in the next **12 months** by the total lifetime **expected credit losses** that would result from that default. Note that this is not the same as the expected cash shortfalls over the next 12 months.

4.3.2 Subsequent treatment of financial asset

An entity may continue to provide for 12-month expected credit losses if there is not a significant change in credit risk. However, the probability of default occurring in the next 12 months may have changed and the credit loss allowance would have to be adjusted to reflect this.

If the **credit risk increases significantly since initial recognition** the 12-month expected credit impairment allowance is replaced by **lifetime expected credit losses**. If the credit quality subsequently improves and the lifetime expected credit losses criterion is no longer met, the 12- month expected credit loss basis is reinstated which means that the credit impairment allowance will reduce.

Definitions

Credit loss: The difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive discounted at the original effective interest rate.

Expected credit losses (ECL): The weighted average of credit losses with the respective risks of the default occurring as the weights.

Lifetime expected credit losses: Those that result from all possible default events over the expected life of a financial instrument.

12-month expected credit losses: The portion of lifetime expected credit losses which represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date.

4.3.3 General or 3-stage approach

The amount of the impairment to be recognised on financial assets **depends on whether or not they have significantly deteriorated** since their initial recognition. For this purpose, financial instruments are classified into three stages as follows:

Step 1 Financial assets on initial recognition and financial assets where credit quality has not significantly deteriorated since initial recognition. Stage 1 contains loans from all risk classes except 'credit-impaired' loans (section 4.4).

Step 2 Financial assets whose credit quality has significantly deteriorated since their initial recognition.

Step 3 Financial assets for which there is objective evidence of impairment at the reporting date.

For Stage 1 financial instruments, the impairment represents the present value of expected credit losses that will result if a default occurs in the 12 months after the reporting date **(12 months' expected credit losses)**.

For financial instruments classified as Stage 2 or 3, an impairment is recognised at the present value of expected credit shortfalls over their remaining life **(lifetime expected credit loss)**. Entities are required to reduce the gross carrying amount of a financial asset in the period in which they no longer have a reasonable expectation of recovery.

4.3.4 Interest

For Stage 1 and 2 instruments interest revenue will be calculated on their gross carrying amounts, whereas interest revenue for Stage 3 financial instruments would be recognised on a net basis (ie, after deducting expected credit losses from their carrying amount).

4.3.5 Summary

The following figure gives a useful summary of the process.

Figure 16.2: The three-stage approach

	Stage 1	Stage 2	Stage 3
When?	Initial recognition (and subsequently if no significant deterioration in credit risk)	Credit risk increases significantly (rebuttable presumption if > 30 days past due)	Objective evidence of impairment exists at the reporting date
Credit losses recognised	12-month expected credit losses	Lifetime expected credit losses	Lifetime expected credit losses
Calculation of effective interest	On gross carrying amount	On gross carrying amount	On carrying amount net of allowance for credit losses after date evidence exists

Worked example: Impairment loss

On 1 January 20X2 Dexter Lee plc originated a loan of £500,000. It classified the financial asset as measured at amortised cost. The loan is fully repayable at the end of Year 5. The effective interest rate is 4% per annum (payable at the end of each year).

On initial recognition, the loan has a low credit risk and the probability of default in the next 12 months is 1% with lifetime credit losses estimated at £125,000.

At 31 December 20X2, there has been no significant deterioration in credit quality and the loan is considered to be low credit risk. The probability of default increases to 1.5% due to marginal increase in credit risk of the borrower. The lifetime credit losses are still estimated at £125,000.

At 31 December 20X3, there has been a significant deterioration of credit quality but there is no objective evidence of impairment loss. The expected credit losses over the remaining life of the loan are estimated at £50,000.

At 31 December 20X4, there is evidence of loss event and the loan defaults. The actual impairment loss is estimated at £125,000.

Requirements

Explain how the loan should be accounted for under IFRS 9 including the following:

(a) Impairment loss allowance to be recognised on origination of the loan and at the end of each of the year ended 31 December 20X2, 20X3 and 20X4 with relevant journal entries.

(b) Amount of interest income to be recognised in each of the years ended 31 December 20X2 to 20X5.

Solution

(a) Impairment loss recognised on origination and adjusted subsequently for changes in credit risk.

Initial recognition

		£
DEBIT	Loan receivable	500,000
CREDIT	Cash	500,000

		£
DEBIT	Impairment loss (P/L)	1,250
CREDIT	Loan asset/loss allowance	1,250

(Based on 12-month expected credit losses = 1% of £125,000) Loan is classified in Stage 1

Year ended 31 December 20X2

		£
DEBIT	Impairment loss (P/L)	625
CREDIT	Loan asset/loss allowance	625

(Based on 12-month expected credit losses = 1.5% of £125,000 less £1,250 previously recognised)

Loan remains in Stage 1 as there is no significant increase in credit risk Interest amount = 4% of £500,000 = £20,000.

Year ended 31 December 20X3

£

DEBIT	Impairment loss (P/L)	48,125
CREDIT	Loan asset/loss allowance	48,125

(Based on lifetime expected credit losses = £50,000 less £1,875 previously recognised) Loan is moved to Stage 2 as there is a significant increase in credit risk

Interest amount = 4% of £500,000 = £20,000.

Year ended 31 December 20X4

£

DEBIT	Impairment loss (P/L)	75,000
CREDIT	Loan asset/loss allowance	75,000

(Based on lifetime expected credit losses = £125,000 less £50,000 previously recognised)

Loan is moved to Stage 3 as it is credit-impaired

Interest amount = 4% of £500,000 = £20,000.

(b) **Year ended 31 December 20X5**

Interest amount in the year ended 31 December 20X5 = 4% of £375,000 = £15,000

The loan has moved to Stage 3 at the end the year ended 31 December 20X4. The interest in the year ended 31 December 20X5 is calculated on the net carrying amount of the loan.

4.3.6 Simplified approach for trade and lease receivables

For trade receivables that do not have an IFRS 15 financing element, the loss allowance is measured at the lifetime expected credit losses, from initial recognition.

For other trade receivables and for lease receivables, the entity can choose (as a separate accounting policy for trade receivables and for lease receivables) to apply the three-stage approach or to recognise an allowance for lifetime expected credit losses from initial recognition.

Worked example: Trade receivable provision matrix

On 1 June 20X4, Kredco sold goods on credit to Detco for £200,000. Detco has a credit period with Kredco of 60 days. Kredco applies IFRS 9, and uses a pre-determined matrix for the calculation of allowances for receivables as follows.

Days overdue	Expected loss provision
Nil	1%
1 to 30	5%
31 to 60	15%
61 to 90	20%
90 +	25%

Detco had not paid by 31 July 20X4, and so failed to comply with its credit term, and Kredco learned that Detco was having serious cash flow difficulties due to a loss of a key customer. The finance controller of Detco has informed Kredco that they will receive payment.

Ignore sales tax.

Requirement

Show the accounting entries on 1 June 20X4 and 31 July 20X4 to record the above, in accordance with the expected credit loss model in IFRS 9.

Solution

On 1 June 20X4

The entries in the books of Kredco will be:

		£
DEBIT	Trade receivables	200,000
CREDIT	Revenue	200,000

Being initial recognition of sales

An expected credit loss allowance, based on the matrix above, would be calculated as follows:

		£
DEBIT	Expected credit losses	2,000
CREDIT	Allowance for receivables	2,000

Being expected credit loss: £200,000 × 1%

On 31 July 20X4

Applying Kredco's matrix, Detco has moved into the 5% bracket, because it has exhausted its 60-day credit period (note that this does not equate to being 60 days overdue!). Despite assurances that Kredco will receive payment, the company should still increase its credit loss allowance to reflect the increased credit risk.

Kredco will therefore record the following entries on 31 July 20X4:

		£
DEBIT	Expected credit losses	8,000
CREDIT	Allowance for receivables	8,000

Being expected credit loss: £200,000 × 5% – £2,000

Worked example: Impairment of trade receivable

Included in Samipa's trade receivables at 31 October 20X8 is an amount due from its customer Dasgupta of £51,542,000. This relates to a sale which took place on 31 October 20X6, payable in three annual instalments of £20,000,000 commencing 31 October 20X7 discounted at a market rate of interest adjusted to reflect the risks of Dasgupta of 8%. Based on previous sales where consideration has been received in annual instalments, the directors of Samipa estimate a lifetime expected credit loss in relation to this receivable of £14.4 million. The probability of default over the next 12 months is estimated at 25%. For trade receivables containing a significant financing component, Samipa chooses to follow the three-stage approach for impairments (rather than always measuring the loss allowance at an amount equal to lifetime credit losses). No loss allowance has yet been recognised in relation to this receivable.

Requirement

How should the receivable be treated in the financial statements?

Solution

A loss allowance for the trade receivable should be recognised at an amount equal to 12-month expected credit losses. Although IFRS 9 offers an option for the loss allowance for trade receivables with a financing component to always be measured at the lifetime expected losses, Samipa has chosen instead to follow the three-stage approach of IFRS 9.

The 12-month expected credit losses are calculated by multiplying the probability of default in the next 12 months by the **lifetime** expected credit losses that would result from the default. Here this amounts to £3.6 million (£14.4m × 25%).

Adjustment:

		£m
DEBIT	Expected credit loss	3.6
CREDIT	Allowance for receivables (this is offset against trade receivables)	3.6

Worked example: Impairment review

Blacksmith holds a financial asset: an investment in debt instruments, measured at amortised cost, which has a carrying amount of £430,000 (before adjustments for impairment and/or fair value changes) at 31 December 20X3. Impairment indicators require an impairment test to be conducted on each asset at 31 December 20X3. The investment in debt instruments has an impairment allowance brought forward at 1 January 20X3 of £6,000 as a Stage 1 12-month expected credit loss based on a probability of default of 2%.

Revised estimated future cash flows, measured as at 31 December 20X3 are:

	20X4	20X5	20X6	20X7	20X8
	£	£	£	£	£
Cash inflows	80,000	80,000	80,000	100,000	100,000

Cash flows are assumed to occur on 31 December each year. The original contractual cash flows for the investment in debt instruments were £100,000 on each of the above dates. The probability of default has increased to 2.5% because of the reduced cash flows.

The investment in debt instruments is held at amortised cost, using an effective interest rate of 5.25%. Its fair value at 31 December 20X3 (due to a rise in market interest rates) is £360,000. It would cost £1,000 in transaction fees to sell the instruments.

Requirement

Discuss how the asset should be accounted for in the financial statements of Blacksmith for the year ended 31 December 20X3.

Solution

An impairment test on financial assets is only required for investments in debt instruments measured at amortised cost or at fair value through other comprehensive income. An impairment allowance is recognised on initial recognition of the debt instrument based on 12-month expected credit losses (ie, lifetime expected credit losses multiplied by the probability of a default arising in the next 12 months). Debt instruments at amortised cost hold an impairment allowance on the statement of financial position (with movements taken to profit or loss). Debt instruments at fair value through other comprehensive income recognise impairment allowances in other comprehensive income (with the movement taken to profit or loss).

An impairment test is performed annually to assess any changes in credit risk. If there is no change in credit risk, the 12-month expected credit losses are recalculated using latest estimates and the asset remains in Stage 1. If there has been a significant increase in credit risk, the asset moves to Stage 2 and lifetime expected credit losses must be calculated and recognised. A significant increase in credit risk is presumed for debts more than 30 days past due. If there is 'objective evidence' of impairment (such as a default in interest or capital payments) the asset moves to Stage 3, lifetime expected credit losses continue to be recognised and interest is calculated on the asset net of the impairment allowance. Default is presumed for debts more than 90 days past due.

Worked example: Portfolio of mortgages and personal loans

Credito Bank operates in South Zone, a region in which clothing manufacture is a significant industry. The bank provides personal loans and mortgages in the region. The average loan to value ratio for all its mortgage loans is 75%.

All loan applicants are required to provide information regarding the industry in which they are employed. If the application is for a mortgage, the customer must provide the postcode of the property which is to serve as collateral for the mortgage loan.

Credito Bank applies the expected credit loss impairment model in IFRS 9, *Financial Instruments*. The bank tracks the probability of customer default by reference to overdue status records. In addition, it is required to consider forward-looking information as far as that information is available.

Credito Bank has become aware that a number of clothing manufacturers are losing revenue and profits as a result of competition from abroad, and that several are expected to close.

Requirement

How should Credito Bank apply IFRS 9 to its portfolio of mortgages in light of the changing situation in the clothing industry?

Solution

Credito Bank should segment the mortgage portfolio to identify borrowers who are employed by clothing manufacturers and suppliers and service providers to the clothing manufacturers. This segment of the portfolio may be regarded as being 'in Stage 2', that is having a significant increase in credit risk. Lifetime credit losses must be recognised.

In estimating lifetime credit losses for the mortgage loans portfolio, Credito Bank will take into account amounts that will be recovered from the sale of the property used as collateral. This may mean that the lifetime credit losses on the mortgages are very small even though the loans are in Stage 2.

Interactive question 10: Particular defaults identified

Later in the year, more information emerged, and Credito Bank was able to identify the particular loans that defaulted or were about to default.

How should Credito Bank treat these loans? See **Answer** at the end of this chapter.

Interactive question 11: Mortgage loans

A bank makes mortgage loans to clients. Interest charged to these clients is SONIA (Sterling Overnight Index Average) + 1%, reset monthly.

The bank recognises that in its portfolio of clients there will be some clients who will experience financial difficulties in the future and will not be able to keep up mortgage payments.

Under the mortgage agreement, the bank takes first legal charge over the mortgaged property and, in the event of a default where payments cannot be rescheduled, the property would be sold to cover unpaid debts.

Requirement

Discuss how revenue relating to the above would be accounted for under IFRS 9.

See **Answer** at the end of this chapter.

4.4 Purchased credit-impaired approach

A financial asset is described as 'credit-impaired' when one or more events that have a negative effect on future expected cash flows have already occurred.

Where financial assets are already credit-impaired when they are purchased/originated, the following approach is taken:

(a) Purchased credit-impaired financial assets are initially measured at the transaction price without an allowance for expected contractual cash shortfalls that are implicit in the purchase price.

(b) Lifetime credit losses are included in the estimated cash flows for the purposes of calculating the effective interest rate.

(c) Interest revenue is calculated on the net carrying amount at the credit-adjusted effective interest rate.

(d) Expected credit losses are discounted using the credit-adjusted effective interest rate determined at initial recognition.

(e) Subsequent changes from the initial expected credit losses are recognised immediately in profit or loss.

4.5 Recognition of credit losses

Impairment losses are recognised in profit or loss with a corresponding credit entry as follows:

Financial asset	Credit entry
Financial assets at amortised cost	Credit an allowance account. This is offset against the carrying amount of the financial asset so that a net position is presented in the statement of financial position.
Financial assets at fair value through other comprehensive income	Credit an 'accumulated impairment amount' in other comprehensive income. The carrying amount remains at fair value in the statement of financial position.
Loan commitments and financial guarantee contracts	Credit a provision account, which is presented as a separate liability.

4.6 Modifications to existing financial assets

Loans and advances may be **subject to modification**, for example, if forbearance terms are offered such as a payment holiday or a reduction in the rate of interest charged.

The modification of cash flows **may lead to derecognition of the existing financial asset** if there is a **substantial change in terms**. Judgement will need to be applied regarding what constitutes a substantial change.

When the modification results in the derecognition of the existing financial asset, the modified financial asset is considered to be a new financial asset. The new financial asset is therefore treated as any other financial asset on initial recognition and a loss allowance equal to 12-month expected credit losses is created.

In rare circumstances, the new asset may be credit-impaired at initial recognition and would be treated according to section 4.4. This could occur if a distressed asset was subject to a substantial modification.

When the modification does not result in the derecognition of the existing financial asset, the entity must assess whether there has been a significant increase in credit risk since initial recognition using the principles outlined in section 4.3.2.

Evidence that the criteria for the recognition of lifetime expected credit losses are no longer met, and that the asset may return from Stage 2 to Stage 1, may include a history of up-to-date and timely payments against modified contractual terms. A customer would need to demonstrate consistently good payment behaviour over a period of time before the credit risk is considered to have decreased. For example, a history of missed payments would not be erased simply by making one payment on time following a modification of the contractual terms.

Worked example: Modification

Melrose Bank originated a loan of £2.3 million to Cosima Ltd on 1 January 20X8. The terms of the loan were that interest at SONIA plus 2.5% would be paid annually in arrears and a bullet capital repayment was due in three years' time. The 12-month expected credit losses on initial recognition were £200,000.

Cosima Ltd suffered cash flow problems during 20X8 and informed Melrose Bank on 31 December 20X8 that it could not make its first interest payment on 31 December 20X8. Melrose Bank assessed Cosima Ltd's cash flow and profit forecasts and offered it forbearance on the loan. Forbearance terms are such that a fixed rate of interest will be charged to enable Cosima to manage its cashflows and the loan term will extend to five years term with a premium on redemption.

Requirement

How should Melrose Bank recognise impairment on the loan to Cosima Ltd in its financial statements for the year ended 31 December 20X8 based on the three-stage general model for expected credit losses?

Solution

The loan to Cosima Ltd should initially be in Stage 1 of the IFRS 9 three-stage general model, which requires 12-month expected credit losses of £200,000 to be recognised.

When forbearance is offered to Cosima Ltd, Melrose Bank must assess whether there is a substantial change in the terms of the loan.

The changes are from variable to fixed interest rate and to the term of the loan and there will be a premium on redemption. If the changes to the terms are considered substantial, the loan should be derecognised on 31 December 20X8 and a new loan recognised on which 12-month expected credit losses are provided. The assessment of subsequent increases in credit risk is based on the date the new loan is recognised. If the changes to the terms are not considered substantial, the original loan continues to be recognised.

Interactive question 12: Modification

Southwold Co originated a 4% fixed rate loan of $3.5 million to Framlingham Inc on 1 May 20X8. The term of the loan was three years, at which point the loan would be repaid in full. Interest is paid annually in arrears.

Framlingham Inc approached Southwold Co on 1 June 20X9 to ask for an extension to the loan of a further two years, making the total loan term five years. Interest continues to accrue at the fixed rate of 4% for the additional two years and is payable at the end of each year.

Requirement

Explain how the modification of the loan to Framlingham Inc should be accounted for in Southwold Co's financial statements for the year ending 31 December 20X9.

Would the accounting treatment change if interest no longer accrued in the additional two years of the loan term?

See **Answer** at the end of this chapter.

5 Application of IFRS 13 to financial instruments

Section overview

The use of fair value accounting is permitted, or required in some instances, by IFRS 9. Additional guidance is provided in IFRS 13 on how the standard is applied to financial assets and liabilities, and own equity instruments.

5.1 Introduction

IFRS 13, *Fair Value Measurement* gives extensive guidance on how the fair value of assets and liabilities should be established. It sets out to:

- define fair value
- set out in a single IFRS a framework for measuring fair value
- require disclosures about fair value measurements

IFRS 13 was covered in Chapter 2 and referred to in section 3 of this chapter. This section gives more detail of its application to financial instruments. Below is a reminder of the definition of fair value and the three-level valuation hierarchy.

IFRS 13 states that valuation techniques must be those which are appropriate and for which sufficient data are available. Entities should maximise the use of relevant **observable inputs** and minimise the use of **unobservable inputs**.

The standard establishes a three-level hierarchy for the inputs that valuation techniques use to measure fair value:

Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date.

Level 2: Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly eg, quoted prices for similar assets in active markets or for identical or similar assets in non-active markets or use of quoted interest rates for valuation purposes.

Level 3: Unobservable inputs for the asset or liability ie, using the entity's own assumptions about market exit value.

5.2 Financial assets

The following should be considered where a financial asset is being fair valued:

(a) If a quoted item has a bid price (the price that buyers are willing to pay) and an ask price (the price that sellers are willing to achieve), the price within the bid-ask spread that is most representative of fair value is used to measure fair value. The use of bid prices for financial assets and the use of ask prices for financial liabilities is permitted but not required. IFRS 13 does not preclude the use of mid-market pricing.

(b) In the case of equity shares, a control premium is considered when measuring the fair value of a controlling interest. Similarly, any non-controlling interest discount is considered when measuring a non-controlling interest.

(c) If an entity holds a position in a single asset or liability (including a position comprising a large number of identical assets or liabilities, such as a holding of financial instruments) and the asset or liability is traded in an active market, the fair value of the asset or liability shall be measured within Level 1 as the product of the quoted price for the individual asset or liability and the quantity held by the entity. That is the case even if a market's normal daily trading volume is not sufficient to absorb the quantity held, and placing orders to sell the position in a single transaction might affect the quoted price.

(d) A subsidiary, associate or joint venture investment in quoted equity shares is always measured as a multiple of the share price, with no adjustment for a premium associated with influence or control.

(e) The valuation of unlisted equity investments involves significant judgment and different valuation techniques are likely to result in different fair values, however this does not mean that any of the techniques are incorrect. Certain techniques are better suited to particular types of business, for example an asset-based approach is relevant to property companies whilst an income-based approach is more relevant to service businesses. It is likely that valuation will be based on some unobservable inputs and as a result the overall fair value will be classified as a Level 3 measurement.

5.3 Liabilities and own equity instruments

Liabilities and own equity instruments must be measured on the assumption that the liability or equity is transferred to a market participant at the measurement date and therefore:

- a liability would remain outstanding and the market participant would be required to fulfil the obligation; and
- an entity's own equity instrument would remain outstanding and the market participant would take on the rights and responsibilities associated with the instrument.

This differs (sometimes significantly so) from a measurement that is based on the assumed settlement of a liability or cancellation of an entity's own equity instrument.

IFRS 13 further requires that the fair value of a liability must factor in non-performance risk. Anything that could influence the likelihood of an obligation being fulfilled is considered a non-performance risk, including an entity's own credit risk.

Worked example: Fair value of liabilities

Crossley Co has a bank loan with a nominal value of £1 million that attracts a market rate of interest. Due to market concern regarding non-performance risk of Crossley Co, the market value of the loan to the bank is just £800,000. The bank will not agree to discount the amount paid by Crossley Co to extinguish the loan.

Miller Co is seeking similar financing to the bank loan and has a similar credit profile to Crossley Co. Miller Co is indifferent to obtaining a new bank loan or assuming Crossley Co's bank loan.

Requirement

What is the fair value (transfer value) of Crossley Co's bank loan?

Solution

As Miller Co has the same credit profile as Crossley Co, if it were to take out a bank loan, the bank would lend only £800,000 (the market value of Crossley Co's loan) in return for the same cash flow as are outstanding in respect of Crossley Co's loan. This is because the bank would require a higher rate of interest to compensate for the increased credit risk.

Therefore the transfer value (fair value) of Crossley Co's loan is £800,000.

Interactive question 13: Fair value of liability

Morden Co and Merton Co individually enter into legal obligations to each pay £200,000 to Wallington Co in seven years' time in exchange for some goods.

Morden Co has a very good credit rating and can borrow at 4%. Merton Co's credit rating is lower and it can borrow at 8%.

Requirement

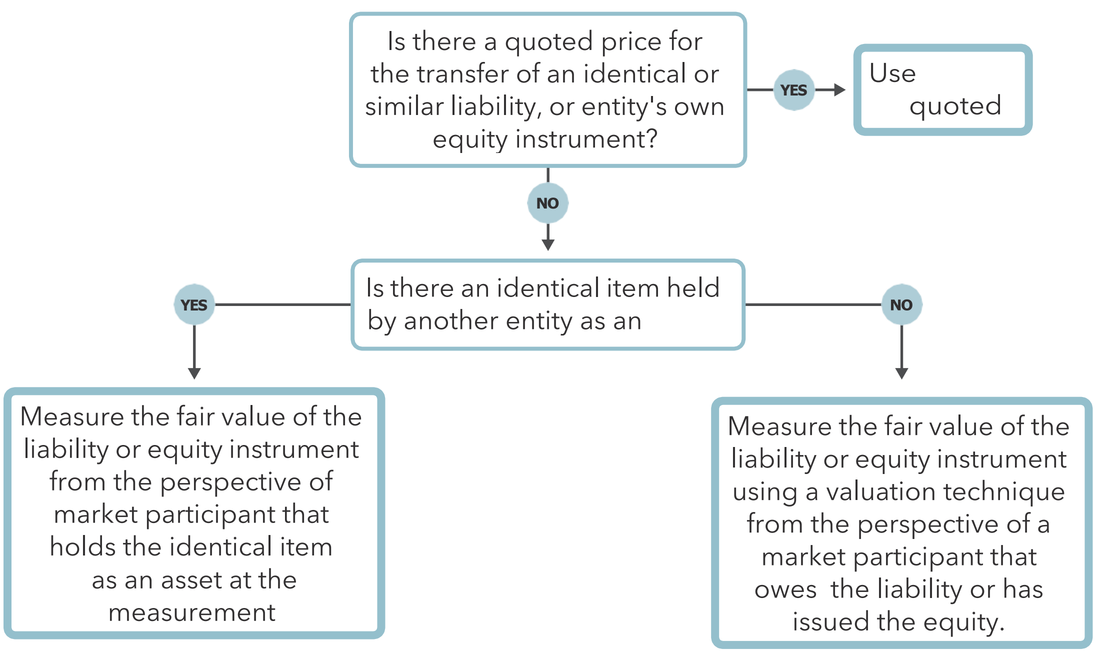
What is the fair value of the legal obligation that Morden Co and that Merton Co must record in their financial statements?

See **Answer** at the end of this chapter.

5.4 Liabilities and own equity instruments

The specific approach to fair value liabilities and an entity's own equity instruments sometimes differs from the concepts to fair value an asset and is summarised in the following flowchart:

Figure 16.3: Fair value of liabilities



6 Derivatives and embedded derivatives

Section overview

- Derivatives are financial instruments whose value changes in response to a change in the value of an underlying security, commodity, currency, index or other financial instrument(s). They normally require a zero, or small, initial net investment and are settled at a future date.
- IFRS 9 requires derivatives to be recognised when the entity becomes a party to the contractual provisions of the contract, rather than when the contract is settled.
- Derivatives are measured at fair value through profit or loss (except for derivatives used as hedging instruments in certain types of hedges).
- An embedded derivative is a component of a hybrid instrument that also includes a non-derivative host contract, and which causes some of the cash flows of the combined instrument to vary in a way similar to a standalone derivative.
- Where the host contract is a financial asset within the scope of IFRS 9, the whole contract is measured at fair value through profit or loss.
- If the host contract is not an asset within the scope of IFRS 9, the embedded derivative should be separated from the host contract and recognised separately as a derivative if:
  - economic characteristics and risks are not closely related to the host contract;
  - a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
  - the hybrid instrument is not measured at fair value through profit or loss

6.1 Definition of a derivative – further examples

The definition of derivative was set out earlier in the summary of the material covered at Professional Level. A quick reminder – it is a financial instrument:

- whose **value changes in response to the change in price of an underlying security, commodity, currency, index or other financial instrument(s)**;
- where the **initial net investment** is zero or is small in relation to the value of the underlying security or index; and
- that is **settled at a future date.**

A derivative normally has a notional amount, such as a number of shares or other quantity specified in the contract. For example, a forward currency contract has a quoted amount of currency even though neither the holder nor, writer is required to invest or receive this amount at the inception of the contract. However, this is not a requirement and a derivative could require a fixed payment or a variable payment based on the outcome of some future event that is unrelated to the notional amount. For example, a contract that requires the fixed payment of £1,000 if a commodity price increases by 5% or more is a derivative.

Common types of derivatives include the following:

- Swaps
- Purchased or written options (call and put)
- Futures
- Forwards

Underlying variables

Examples of underlying variables attaching to the derivatives include the following:

- Interest rates
- Currency rates
- Commodity prices
- Equity prices
- Credit-related variables

In determining whether a derivative exists, the substance of the transaction should be considered. Non-derivative transactions should be aggregated and treated as derivatives when the transactions result, in substance, in derivatives. For example, if Entity A grants a fixed rate loan to Entity B and in return Entity B grants a variable rate loan of the same amount and maturity, both entities should treat the arrangement as an interest rate swap and account for it as a derivative.

a. A defining characteristic of a derivative is that it **requires either no initial investment or an initial net investment smaller than would be required for other types of contracts** that would be expected to have a similar response to changes in market factors. A purchased call option contract, for example, meets this definition because the premium is less than the investment that would be required to obtain the underlying financial instrument to which the option is linked.

b. An interest rate swap in which the parties settle on a net basis qualifies as a derivative instrument. This is because the definition of a derivative makes reference to future settlement, but not to the method of settlement.

c. If a party prepays its obligation under a **pay-fixed, receive-variable interest rate swap** at inception, the swap should be classified as a **derivative**.

d. However, if the fixed rate payment obligation is **prepaid subsequent to initial recognition** this would be regarded as a **termination of the old swap** and an origination of a new instrument.

e. A **prepaid pay-variable**, **receive-fixed interest rate swap is not a derivative if it is prepaid at inception**, and it is no longer a derivative if it is prepaid after inception because it provides a return on the prepaid (invested) amount comparable to the return on a debt instrument with fixed cash flows. The prepaid amount fails the 'no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors' criterion of a derivative.

f. An **option** which is **expected not to be exercised**, for example because it is 'out of the money', **still qualifies as a derivative**.

   This is because an option is settled upon exercise or at its maturity. Expiry at maturity is a form of settlement even though there is no additional exchange of consideration.

g. Many derivative instruments, such as futures contracts and exchange-traded written options, require margin accounts.

   The **margin account** is **not part of the initial net investment in a derivative** instrument. Margin accounts are a form of collateral for the counterparty or clearing house and may take the form of cash, securities or other specified assets, typically liquid assets. Margin accounts are separate assets that are accounted for separately.

h. A derivative **may have more than one underlying variable**.

i. A **contract to buy or sell a non-financial asset** is a derivative if:

(1) it can be settled net in cash or by exchanging another financial instrument; and

(2) the contract was **not** entered for the purpose of receipt or delivery of the non-financial item to meet the entity's expected purchase, sale or usage requirements.

An example would be a gas supply contract in the UK (where there is an active market) where the supplier or purchaser has the right to refuse delivery or receipt of the gas for financial reasons, for example because they can get a better price in the market. However, if the right to refuse delivery on the part of the seller can only be invoked for operational reasons (ie, they do not have the gas available to supply), this does not on its own make the contract a derivative.

6.1.1 Currency swaps

A currency swap (or cross-currency swap) is an interest rate swap with cash flows in different currencies. It is an agreement to make a loan in one currency and to receive a loan in another currency. With the currency swap there are three sets of cash flows. Initially, the underlying principals are exchanged when the swap starts; interest payments are then made over the life of the swap; and finally the underlying principal amounts are re-exchanged.

A currency swap could also be interpreted as issuing a bond in one currency (and paying interest on this bond) while investing in a bond in another currency (and receiving interest on this bond).

Worked example: Currency swap

Two entities enter into a 10-year fixed currency swap of euros (€) and pounds (£). Current interest rates relating to € and £ are 4% and 6% respectively. At inception of the contract the current rate of exchange is €2 per £1. The contract requires the initial exchange of €2,000 and £1,000.

Annual interest payments are made between the parties without netting of €80 (4% × €2,000) and
£60 (6% × £1,000). After 10 years, the swap terminates and the original principal amounts are returned.

Requirement

Does the instrument fit the definition of a derivative?

Solution

The currency swap meets the definition of a derivative, as the exchange of the initial fair values means there is zero initial investment, its value changes in response to a specified exchange rate and it is settled at a future date.

Interactive question 14: Loan agreement as derivatives

Two entities make loans to each other for the same amount and on the same terms except that one is based on a fixed rate of interest and the other on a variable rate of interest. There are no transfers of principal at inception of the transaction since the two entities have a netting agreement.

Requirement

Does the transaction fit the definition of a derivative? See **Answer** at the end of this chapter.

Worked example: Forward contract to buy commodity

SML, a tools manufacturer, entered into a contract to buy 50 tonnes of steel in 12 months' time, in accordance with its expected use requirements. The contract permits SML to take physical delivery of the steel or to pay or receive a net settlement in cash based on the change in the market price of steel.

Requirement

Is the contract a derivative?

Solution

The contract meets some of the criteria of a derivative; that is, there is no initial investment and it is to be settled at a future date. However, because the underlying is a non-financial asset, classification as a derivative will depend on whether the contract was entered into in order to benefit from short-term price fluctuations by selling it. If SML intends to take delivery of the steel and use it as an input in its production process, then the contract is not a derivative.

6.2 Accounting for derivatives

As noted previously, derivatives are classified as held for trading (unless they are hedging instruments – see the next chapter), so they should be **measured at fair value and changes in fair value should be recognised in profit or loss**. The following example highlights the accounting treatment of derivatives.

Context example: Accounting treatment of purchased option

On 31 December 20X0, Theta purchases put options over 100,000 shares in Omega which expire on 31 December 20X2. The exercise price of the option is £2, the market price on 31 December 20X0 and the premium paid is £11,100.

The intrinsic value of the option (i.e., the exercise price less the price per share, times the number of shares specified in the option contract) is zero at acquisition. The cost of £11,100 reflects the time value of the option which depends on the time to expiration, the price of the stock and its volatility.

If the stock price falls below £2 the put becomes in the money by the amount below the £2 strike price times the number of option shares. For instance, if the price of Omega stock fell to £1.90, the intrinsic value gain on the put option is £0.10 per share. If the stock price rises and stays above £2 for the term of the contract, the put option expires worthless to the buyer because it is out of the money. The purchaser of the put option loses the premium which is kept by the seller (writer).

Economic assumptions

The value of the shares in Omega and the put options are shown in the table below. The value of the put option increases as the stock price decreases.

	31.12.20X0	30.6.20X1	31.12.20X1
Omega shares	**£**	**£**	**£**
Price per share	2.00	1.90	1.85
Value of put option	11,100	13,500	15,000

On 31 December 20X1, Theta sells the option.

CHAPTER 16

Accounting entries under IFRS 9:

	Debit	Credit
31 December 20X0	**£**	**£**
Financial asset – put option Cash	11,100	
(To record the purchase of the put option)		11,100
30 June 20X1		
Financial asset – put option (13,500 – 11,100)	2,400	
Profit or loss – gain on put option		2,400
(To record the increase in the fair value of the put option)		
31 December 20X1		
Financial asset – put option (15,000 – 13,500)	1,500	
Profit or loss – gain on put option		1,500
(To record the increase in the fair value of the put option) Cash	15,000	
Financial asset – put option		15,000
(To record the sale of the put option on 31.12.20X1)		

6.3 Embedded derivatives

Certain contracts that are not themselves derivatives (and may not be financial instruments) include derivative contracts that are 'embedded' within them.

Definition

Embedded derivative: A component of **a hybrid (combined) instrument** that also includes a **non- derivative host contract** – with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.

6.4 Embedded derivatives: the basics

Below we look at some basic examples and their treatment. Then we will look in detail at more complex issues.

Examples of host contracts

Possible examples include the following:

(a) An investment in a debt instrument that is convertible into ordinary shares of the issuer. The debt instrument is the host contract and the conversion option is the embedded derivative.

(b) A debt instrument with an extension option with the interest rate in the extension period reset to 1.2 times the market rate. The debt instrument is the host contract with embedded extension option.

(c) A lease contract has a rent adjustment clause based on changes in the local inflation rate. The lease is the host contract with inflation-related rentals being the embedded derivative.

Examples of embedded derivatives

Possible examples include:

(a) A construction contract priced in a foreign currency. The construction contract is a non-derivative contract, but the changes in foreign exchange rate is the embedded derivative.

(b) A bond which is redeemable in five years' time, with part of the redemption price being based on the increase in the FTSE 100 Index:

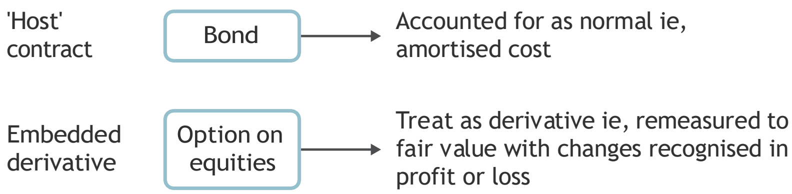


Figure 16.4: Embedded derivatives

Accounting treatment of embedded derivatives

The basic rule for accounting for an embedded derivative is that, if the host contract is a financial asset within the scope of IFRS 9, the whole contract is measured as at fair value through profit or loss.

Context example: Embedded derivative – host is a financial asset

Myrtle plc has made an investment in a bond which has interest payments linked to the price of platinum.

The bond investment is a financial asset within the scope of IFRS 9, therefore the entire contract is measured at fair value through profit or loss.

If the host contract is not a financial asset within the scope of IFRS 9, the embedded derivative should be separated from its host contract and accounted for separately as a derivative. The purpose is to ensure that the embedded derivative is measured at fair value and any changes in its fair value are recognised in profit or loss. But this separation should only be made when the following conditions are met:

(a) The **economic characteristics** and risks of the embedded derivative are **not closely related** to the economic characteristics and risks of the **host contract**.

(b) A **separate instrument** with the same terms as the embedded derivative **would meet the definition** of a **derivative**.

(c) The hybrid (combined) instrument is **not measured at fair value with changes in fair value recognised inprofit or loss** (if changes in the fair value of the total hybrid instrument are recognised in profit or loss, then the embedded derivative is already accounted for on this basis, so there is no benefit in separating it out).

The meanings of **'closely related'** and **'not closely related'** are dealt with in more detail below.

Note that an entity may, subject to conditions, **designate a hybrid contract as at fair value through profit or loss**, thereby avoiding the need to measure the fair value of the embedded derivative separately from that of the host contract.

The conditions for classifying the entire hybrid contract as at fair value through profit or loss are as follows:

(a) If the host contract is not an asset within the scope of IFRS 9, an entity may designate the whole contract as at fair value through profit or loss unless:

(1) the embedded derivative does not significantly modify the host contract's cash flows; or

(2) it is clear with little or no analysis that separation of the embedded derivative is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.

(b) If the entity is required to separate the embedded derivative but it cannot be measured separately, the entity may designate the entire contract as at fair value through profit or loss.

If the fair value of the embedded derivative cannot be determined due to the complexity of its terms and conditions, but the value of the hybrid and the host can be determined, then the **value of the embedded derivative** should be determined as the **difference between the value of the hybrid** and the **value of the host contract**.

Context example: Embedded derivative – host is not a financial asset (1)

Zainab Co leases machinery to Kool Ltd to produce a new product. The payments under the lease are determined by reference to the sales Kool Ltd makes of the new product.

The variable lease payments are created by an embedded derivative within the lease host contract. The embedded derivative is based on the underlying sales of the new product.

The host contract (the lease) is not a financial asset under IFRS 9. Zainab Co may not separate the embedded derivative from the host contract because it is closely related to the host. The whole hybrid instrument may be designated at fair value through profit or loss.

Context example: Embedded derivative – host is not a financial asset (2)

Ayia Co has a lease contract with a rent adjustment clause based on changes in the inflation rate. The lease contract (outside the scope of IFRS 9) contains an embedded derivative based on inflation.

The embedded derivative is not separated from the lease contract because it is considered to be closely related to the host lease contract.

If the lease contract has a rent adjustment clause based on leveraged inflation (say twice the change in the inflation rate), the embedded derivative must be separated because it is not closely related to the host contract.

6.5 Key characteristics of embedded derivatives

An embedded derivative **causes some or all of the cash flows of the host contract to be modified**, based on a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of price or rates, credit rating or credit index or other variables. As a result, the financial payoffs of the hybrid instrument will resemble those of a standalone derivative.

A **key characteristic** of embedded derivatives is that the **embedded derivative cannot be transferred** to a third party independently of the instrument. For example, the embedded equity option in a convertible bond cannot be exercised with the bond being retained. If the conversion option is exercised, the bond will have to be derecognised. This is different from a bond with a detachable warrant, which gives the right to the owner to exercise the warrant and buy shares while retaining the bond. This is not a hybrid or combined instrument. The warrant is a separate financial instrument, not an embedded derivative.

6.6 Separation of host and embedded derivatives

If the host contract within a hybrid instrument is not a financial asset under IFRS 9, the embedded derivative may need to be separated out. Whether there is a requirement to separate the host contract from its embedded derivative can require complex analysis. The three conditions above must be met. This diagram shows how these three conditions should be tested for.

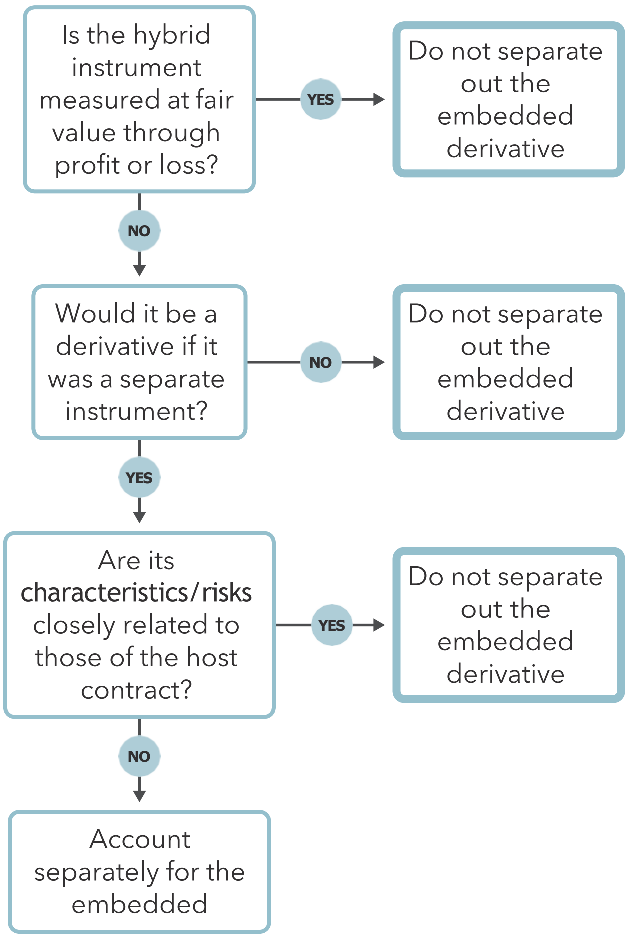


Figure 16.5: Establishing the treatment of embedded derivatives

6.7 Identification of embedded derivatives

Embedded derivatives can be structured deliberately, as has been already mentioned, or they **may arise inadvertently**. An example of this would be a **currency that is different from the functional currencies of both the buyer and seller of goods**. Multiple embedded derivatives are treated as if they were a single embedded derivative, unless they relate to different risk exposures which can be identified and separated, in which case they can be accounted for separately.

Although, theoretically, the host of an embedded derivative could be any type of contract that is not recorded at fair value, in practice there is a small number of contracts that have derivatives embedded in them, the most common of which are:

- debt instruments
- equity instruments

- leases
- insurance contracts
- executory contracts such as purchase and sale contracts

The identification of embedded derivatives requires the entity to consider all executory contracts such as purchases and sales contracts, and commitments.

For example, an embedded derivative may be identified if contracts contain:

- rights or obligations to **exchange** at some time in the future;
- rights or obligations to **buy or sell**;
- provisions for **adjusting the cash flows** according to some interest rate, price index or specific time period;
- options which permit either party to **do something not closely related** to the contract; and/or
- unusual **pricing terms** (e.g., a lease which charges interest at rates linked to the FTSE 100 (Financial Times Stock Exchange) yield contains an embedded swap).

Finally, a comparison of the terms of a contract (such as maturity, cancellation or payment provisions) with the terms of another similar, non-complex contract may indicate the existence, or not, of an embedded derivative.

6.8 Examples of embedded derivatives not closely related

Examples where the embedded derivative is **not** closely related to the **host instrument** include the following:

- The option to **extend the term** on a fixed rate debt instrument without resetting the interest rate to market rates
- **Credit derivatives** in a debt instrument
- A **put option** embedded in an instrument that enables the holder to require the issuer to reacquire the instrument for an amount of cash or other assets, which varies on the basis of the change in an equity or commodity price or index
- **Equity-indexed interest or principal payments** embedded in a host debt instrument or insurance contract
- **Commodity-indexed interest or principal payments** embedded in a host debt instrument or insurance contract
- A **call, put, or prepayment option** embedded in a host debt contract or host insurance contract
- Credit derivatives that are embedded in a host debt instrument allowing the transfer of credit risk from one party to another.

In all of the above circumstances, the embedded derivative is separated out from the host contract for accounting purposes.

6.9 Examples of closely related embedded derivatives

No definition of 'closely related' is included in IFRS 9. In general, an embedded derivative is considered to be **closely related if it modifies** the **inherent risk of the combined contract but leaves the instrument substantially unaltered**. Some common examples of closely related embedded derivatives are given below.

- An embedded derivative based on an interest rate (or interest rate index) that can **change the amount of interest otherwise paid or received** on an interest-bearing debt or insurance host contract.
- An **embedded floor or cap** on the interest rate on a debt contract or insurance contract,

provided the floor is at or below, and the cap is at or above, the market rate of interest when the contract is issued, and the cap or floor is not leveraged in relation to the host contract.

- An **embedded foreign currency derivative** that provides a stream of principal or interest payments that are denominated in a foreign currency and is embedded in a host **debt instrument** (e.g., a dual currency bond). Such a derivative is not separated from the host instrument because IAS 21 requires foreign currency gains and losses on monetary items to be recognised in profit or loss.
- An **embedded foreign currency derivative** in a host contract that is an **insurance contract** or not a financial instrument (such as a contract to purchase a non-financial item where the price is denominated in a foreign currency), provided the payment is to be in the functional currency of one of the substantial parties to the contract, or in the currency in which the contracted good or service is routinely denominated (such as the US dollar for crude oil transactions).
- An **embedded prepayment option** in an interest-only or principal-only strip is closely related to the host contract provided the host contract initially resulted from separating the right to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative, and does not contain any terms not present in the original host debt contract.
- An embedded derivative in a host lease contract is closely related to the host contract if the embedded derivative is an **inflation-related index** such as an index, of lease payments to a consumer price index (provided that the lease is not leveraged and the index relates to inflation in the entity's own economic environment), contingent rentals based on related sales or contingent rentals based on variable interest rates.
- A **unit-linking feature** embedded in a host financial instrument or host insurance contract is closely related to the host instrument or host contract if the unit-denominated payments are measured at current unit values that reflect the fair values of the assets of the fund. A unit-linking feature is a contractual term that requires payments denominated in units of an internal or external investment fund.
- A derivative **embedded in an insurance contract** is closely related to the host insurance contract if the embedded derivative and host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately (i.e., without considering the host contract).

In all of the above circumstances, the hybrid contract is accounted for as a whole – the embedded derivative is not separated out.

6.10 Accounting for embedded derivatives

A common transaction involving an embedded derivative is the purchase or sale of goods at a price denominated in a foreign currency – for example, the purchase by an entity of 100 items for $10 each with settlement in 90 days, where the functional currency of the purchasing entity is the pound (£).

Under the guidance set out above, the embedded derivative should be separated out unless:

- the vendor's functional currency is the dollar ($); or
- the items in the transaction are routinely denominated in dollars in international commerce.

The terms of non-option-based derivatives, such as forwards and swaps, should be determined such that the derivative has a fair value of nil at inception. Option-based derivatives, such as puts, swaptions (an option on a swap), and caps, should be separated based on the terms in the contract. Multiple embedded derivatives are required to be separated as a single compound embedded derivative.

Interactive question 15: Embedded derivatives

Moorgate plc is based in the UK and has sterling (£) as its functional currency. In the ordinary course of business it entered into the following contracts:

Contract (1)

Supply of services to Blue Co which operates in Andlay, whose functional currency is the CU. Under the contract Moorgate plc will supply services for a fixed price of INR12 million and is due to receive INR3 million in each of the next four years. The INR is infrequently used as the measure of contract prices in UK or Andlay.

Contract (2)

Issue of debt in £ with interest payable at SONIA plus credit spread of 100 basis points. SONIA at issuance is 1.5% so the rate at inception of the debt is 2.5%. The debt contract provides that if SONIA were to rise, the rate payable on the debt would not rise above 4%.

Neither contract is measured at fair value through profit or loss.

Requirement

Explain in respect of each contract whether there is an embedded derivative and, if so, whether it should be recognised separately in the financial statements of Moorgate plc.

See **Answer** at the end of this chapter.

6.11 Reassessment of embedded derivatives

IFRS 9 addresses the question of whether it is necessary to reassess the treatment of an embedded derivative throughout the life of a contract if certain events occur after an entity first becomes a party to the contract. **It concludes that reassessment is not permitted unless there is a significant change to the terms of the contract.**

6.12 Impact on financial statements

Derivatives and embedded derivatives are measured at fair value with changes in fair value recognised in profit or loss. Derivative contracts are entered into for both trading and risk management purposes. Derivatives enable entities to hedge against fair value or cash flow exposures. Banks should be clear about the objectives of originating such exposures that are likely to have a significant impact on the financial statements. It is important to regularly review the exposures and accounting treatment of derivatives as their values are subject to changes in value of an underlying, which is generally beyond the control of the entity. The fair value movements can have a significant impact on the financial performance and financial position of the entity.

The auditors have to verify that the principles in IFRS 9 are appropriately applied to identify and account for embedded derivatives. An assessment of management judgement (on whether an embedded derivative is closely related to the host contract) is required since this is a factor in determining whether the embedded derivative should be separated or not. The auditors may need to review in detail the terms and conditions of the hybrid contract.

Professional skills focus: Concluding, recommending and communicating

This complex area involving management judgement requires considerable communication skills. Professional scepticism is important, and if the auditors disagree with management's assessment, they will need to support their reasons for doing so.

7 Current developments

Section overview

This section deals with a new discussion paper on financial instruments with the characteristics of equity.

7.1 Financial instruments with the characteristics of equity

The issue of distinguishing, in some cases, between equity and debt has been an IASB project since 2010. The significance of the distinction was discussed in Chapter 15 in connection with IAS 32, *Financial Instruments: Presentation*. In practice, the debt/equity distinction may not be clear cut.
Classification of financial instruments as debt or equity can have a significant effect on the financial statements.

The project is linked to the *Conceptual Framework* as the complexity of questions around distinguishing between liabilities and equity meant that these were excluded from the project to revise the *Conceptual Framework*. The revised framework therefore includes a revised definition of a liability and new supporting guidance, but the definition of equity remained unchanged.

7.1.1 2018 Discussion Paper

In 2018, the IASB issued a Discussion Paper, *Financial Instruments with Characteristics of Equity*. The main proposals are as follows:

(a) At least initially, the main principle of IAS 32 is to remain unchanged. In other words, equity is a **residual** that remains if the characteristics of a financial liability are not fulfilled.

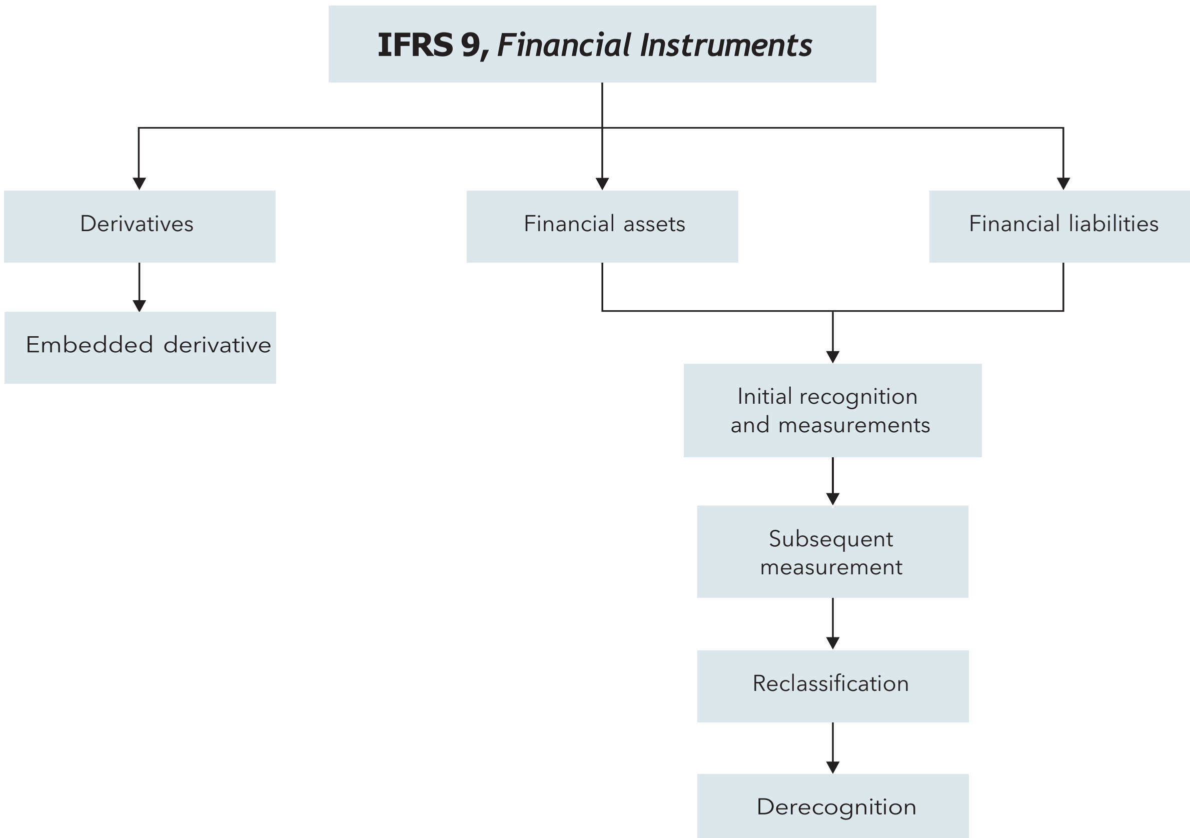
(b) Accordingly, a financial instrument must be classified as a financial liability if its contractual terms contain an unavoidable obligation:

(1) to transfer cash or another financial asset at a specified time other than at liquidation (**timing feature**); and/or

(2) for an amount independent of the entity's available economic resources (**amount feature**).

The IASB met in June 2022 to continue its discussions on the reclassification of financial instruments issued by an entity as financial liabilities or equity instruments when the substance of the contractual terms changes without a modification to the contract. Its decisions so far are tentative.

Summary



IFRS 9, *Financial Instruments*
Derivatives
Financial assets
Financial liabilities
Embedded derivative
Initial recognition and measurements
Subsequent measurement
Reclassification
Derecognition

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Can you distinguish between debt instruments at amortised cost and debt instruments at FVTOCI? (Topic 1)
2.	Which financial liabilities are valued at FVTOCI? (Topic 1)
3.	Can you apply the business model test? (Topic 2)
4.	Can you apply IFRS 13, *Fair Value Measurement* to a financial instrument? (Topic 4)
5.	Can you apply the correct financial reporting treatment for embedded derivatives? (Topic 6)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Trowbridge	This is an amortised cost calculation requiring journal entries and knowledge of the IFRS 9, *Financial Instruments* business model. It builds on simpler calculations at Professional Level.
Longridge	One of the trickier areas of IFRS 9 is impairment and the expected credit loss model. This question should be a good stepping stone to this topic should it come up in the exam.
Gaia	This provides further practice at expected credit losses with the emphasis on explaining rather than calculating.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios to help you improve knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Robicorp	This question tests derecognition, fair value of an equity instrument and fair value of an interest-free loan to employees.
Expando	You are required to show the correct treatment – the company has treated it incorrectly – and to consider auditing issues.
Verloc	This requires a detailed discussion on derecognition of a financial liability.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving onto the next chapter.

1 IFRS 9, *Financial Instruments*

Recognition and measurement

- Initial recognition – **IFRS 9.3.1.1**
- Regular way purchase or sale – **IFRS 9.3.1.2, B3.1.3-B3.1.6**
- Derecognition of financial assets – **IFRS 9.3.2**
- Initial measurement – **IFRS 9.5.1**
- Subsequent measurement of financial assets – **IFRS 9.5.2**
- Subsequent measurement of financial liabilities – **IFRS 9.5.3**
- Amortised cost measurement – **IFRS 9.5.4**
- Embedded derivatives – **IFRS 9.4.3**

Impairment

- IFRS 9 impairment of financial assets
  - General approach – **IFRS 9.5.5.1–5.5.8**
  - Significant increase in credit risk – **IFRS 9.5.5.9–11, B5.5.15–24**
  - Collective and individual assessment – **IFRS 9.B5.5.1–6**
  - Purchased or originated credit-impaired assets – **IFRS 9.5.5.13**
  - Simplified approach – **IFRS 9.5.5.15–16**
  - Measurement of expected credit losses – **IFRS 9.5.5.17–20, B5.5.28–35**
  - Reasonable and supportable information – **IFRS 9.B5.5.49–5**

Self-test questions

Answer the following questions.

1 Stripe Co

On 6 November 20X3 Stripe Co acquires an equity investment with the intention of holding it in the long term. The investment cost £500,000. At Stripe Co's year end of 31 December 20X3, the market price of the investment is £520,000.

Stripe Co has elected to present the equity investment at FVTOCI.

Requirement

How is the asset initially and subsequently measured?

2 Trowbridge Co

On 1 January 20X8, Trowbridge Co purchased 1,000 bonds issued by Spectra Tech Limited for
£97,327. The remaining period to maturity on these bonds is three years and the bonds will be held until maturity when they will be redeemed at par. The par value of each bond is £100.

The annual coupon on these bonds, receivable in arrears, is 5% and the effective interest rate is 6%.

Requirement

Present journal entries to show how the bond asset and related income are recognised over the three years ending 31 December 20X8, 20X9 and 20Y0 if the bonds are in the business model of being held to collect contractual cash flows.

3 Purple Company

During 20X1, The Purple Company invested in 80,000 shares in a stock market quoted company. The shares were purchased at £4.54 per share. The broker collected a commission of 1% on the transaction.

Purple elected to measure these shares at fair value through other comprehensive income.

The quoted share price at 31 December 20X1 was £4.22–£4.26.

Purple decided to 'bed and breakfast' the shares to realise a tax loss, and therefore sold the shares at market price on 31 December 20X1 and bought the same quantity back the following day. The market price did not change on 1 January 20X2. The broker collected a 1% commission on both the transactions.

Requirement

Explain the IFRS 9 accounting treatment of the above shares in the financial statements of Purple for the year ended 31 December 20X1 including relevant calculations.

4 Marland

The Marland Co is preparing its financial statements for the year ended 30 April 20X5. Included in Marland's trade receivables is an amount due from its customer, Metcalfe, of

£128.85 million. This relates to a sale which took place on 1 May 20X4, payable in three annual instalments of £50 million commencing 30 April 20X5 discounted at a market rate of interest adjusted to reflect the risks of Metcalfe of 8%. Based on previous sales where consideration has been received in annual instalments, the directors of Marland estimate a lifetime expected credit loss of £75.288 million in relation to this receivable balance. The probability of default over the next 12 months is estimated at 25%. For trade receivables containing a significant financing component, Marland chooses to follow the three-stage approach for impairments (rather than always measuring the loss allowance at an amount equal to lifetime credit losses). No loss allowance has yet been recognised in relation to this receivable.

Requirement

Explain, with supporting calculations, how this receivable should be accounted for in the financial statements of Marland for the year ended 30 April 20X5.

5 Longridge Co

Longridge Co purchased a bond on 1 January 20X8 for its par value of £100,000 and measures it at fair value through other comprehensive income. The instrument has a contractual term of five years and an interest rate of 5%, payable annually in arrears on 31 December. The 12-month expected credit losses on origination are £1,000.

On 31 December 20X8, the fair value of the debt instrument has decreased to £96,000 as a result of changes in market interest rates. There has been no significant increase in credit risk since initial recognition, and expected credit losses are measured at an amount equal to 12-month expected credit losses, amounting to £1,500.

On 1 January 20X9, the company sells the bond for its fair value of £96,000.

Requirement

Explain the impact of the above transactions in 20X8 and 20X9 on profit or loss, other comprehensive income and the statement of financial position under IFRS 9.

6 Gaia Bank

Gaia Bank holds a portfolio of credit card loans held at £460 million on its statement of financial position at 31 December 20X8. Gaia Bank intends to collect contractual cash flows of interest and principal repayments from its customers. The average balance on each credit card is approximately
£1,200. On average, the probability of default on initial recognition is 18% and the loss given default is 90%. Impairment allowances are assessed collectively for unsecured lending on credit cards.

The probability of default remains the same over the product life. Gaia Bank does not classify credit card loans and receivables as Stage 3 until required payments are outstanding for more than 120 days.

Requirement

Explain the correct financial reporting treatment of the credit card loans and advances under IFRS 9.

7 Pike

The Pike Company issued £18 million of convertible bonds at par on 31 December 20X7. Interest is payable annually in arrears at a rate of 11%. The bondholders can convert into 8 million ordinary shares after 31 December 20Y1.

The bond has no fixed maturity and contains a call option whereby Pike can redeem the bond at any time at par value.

At 31 December 20X7, a bond with a similar credit status and the same cash flows as the one issued by Pike, but without conversion rights or a call option, is valued in the market at £11 million.

Using an option pricing model, it is estimated that the value of the call option on a similar bond without conversion rights would be £3 million.

Requirement

What carrying amount should be recognised for the liability in respect of the convertible bond in the statement of financial position of Pike at 31 December 20X7, in accordance with IAS 32, *Financial Instruments*: *Presentation*?

8 Mullet

The Mullet Company issued £55 million of convertible bonds at par on 31 December 20X7. Interest is payable annually in arrears at a rate of 8%. The bondholders can convert into 20 million ordinary shares after 31 December 20Y1.

The bond has no fixed maturity and contains a call option whereby Mullet can redeem the bond at any time at par value.

At 31 December 20X7, a bond with a similar credit status and the same cash flows as the one issued by Mullet but without conversion rights or a call option is valued in the market at £52 million.

Using an option pricing model it is estimated that the value of the call option on a similar bond without conversion rights would be £1 million.

Requirement

What carrying amount should be recognised for the equity element of the convertible bond in the statement of financial position of Mullet at 31 December 20X7, in accordance with IAS 32, *Financial Instruments*: *Presentation*?

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

1.1 The redeemable preference shares require regular distributions to the holders, but more importantly have the debt characteristic of being redeemable. Therefore, according to IAS 32 they should be classified as debt (a financial liability).

1.2 According to IFRS 2, *Share-based Payment* the grant of share options must be recognised in equity. Share options are an alternative to cash as remuneration, so an expense should be measured in profit or loss with a credit to equity.

Answer to Interactive question 2

2.1 A guarantee to replace or repair goods sold by a business in the normal course of business does not fall within the definition of a financial liability, so it should be dealt with under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

2.2 A firm commitment (order) to purchase a specific quantity of cocoa beans for use in manufacturing is not a financial liability. This is a normal operating purchase which is not recognised until delivery when there is a contractual obligation on the part of the purchaser to pay for the cocoa beans.

2.3 A forward contract such as this falls within the definition of a derivative, so in principle it does fall within IFRS 9. The only exception would be if the contract is for the entity's expected usage of cocoa beans in its business (outside the scope of IFRS 9). This would be accounted for as a normal purchase on delivery, as in requirement 2.

Answer to Interactive question 3

1 January 20X2

		£	£
DEBIT	Loan (£9,500 + £250 legal fees)	9,750	
CREDIT	Cash		9,750

31 December 20X2

		£	£
DEBIT	Cash	1,000	
CREDIT	Interest income (£9,750 × 9.48%)		924
CREDIT	Loan (bal fig)		76

Note: Loan balance is now £9,674 (£9,750 – £76).

31 December 20X3

		£	£
DEBIT	Cash	1,000	
CREDIT	Interest income (£9,674 × 9.48%)		917
CREDIT	Loan (bal fig)		83

Note: Loan balance is now £9,591 (£9,674 – £83).

31 December 20X4

			£
DEBIT	Cash (£9,500 + £1,000)	10,500	
CREDIT	Interest income (£9,591 × 9.48%)		909
CREDIT	Loan (bal fig)		9,591

Answer to Interactive question 4

The objective of E Co's business model is to hold financial assets to collect contractual cash flows. Selling financial assets is only incidental to E Co's business model.

Answer to Interactive question 5

This is a derecognition issue. Legally the debt instrument remains the property of the entity. However, in order to determine whether the investment in the debt instrument should be derecognised, the entity needs to establish if substantially all the risks and rewards of ownership have been transferred.

In this case, the risks and rewards relating to the interest cash flows generated by the asset have been transferred because the entity has no obligation to compensate the third party for any cash flows not received ie, the third party suffers the risk. This is not the case for the ultimate maturity cash flow (the principal).

Under IFRS 9, where an entity transfers substantially all the risks and rewards of part of a financial asset, that part is derecognised providing that part comprises only specifically identified cash flows. An interest rate strip is given as an example by the standard.

Any difference between the proceeds received and the carrying amount (measured at the date of derecognition) of the interest cash flows derecognised is recognised in profit or loss. The amount derecognised is calculated by multiplying the carrying amount of the debt instrument by the proportionate fair value of the interest flows versus the whole fair value of the debt instrument, both at the date of the transfer. This leaves a 'servicing asset' (the principal element) which continues to be recognised.

Answer to Interactive question 6

6.1 ABC should derecognise the asset as its option to repurchase is at the prevailing market value.

6.2 DEF should not derecognise the asset as it has retained substantially all the risks and rewards of ownership. The stock should be retained in its books even though legal title is temporarily transferred.

6.3 XYZ has received 90% of its transferred receivables in cash, but whether it can retain this amount permanently is dependent on the performance of the factor in recovering all of the receivables. XYZ may have to repay some of it and therefore retains the risks and rewards of 100% of the receivables amount. The receivables should not be derecognised. The cash received should be treated as a loan.

The 10% of the receivables that XYZ will never receive in cash should be treated as interest over the six-month period; it should be recognised as an expense in profit or loss and increase the carrying amount of the loan.

At the end of the six months, the receivables should be derecognised by netting them against the amount of the loan that does not need to be repaid to the factor. The amount remaining is bad debts which should be recognised as an expense in profit or loss.

Answer to Interactive question 7

Trade date accounting

The financial asset should be derecognised on 27 December 20X8 and a receivable of £3,250 recognised. At the same date, a gain of £250 should be recognised in profit or loss, which includes any previous gains recognised in other comprehensive income which are now reclassified to profit or loss.

On 5 January 20X9, the counterparty pays the £3,250 to clear the receivable.

Settlement date accounting

- The financial asset should be re-measured at the fair value of £3,250 on 27 December 20X8. The cumulative gain of £250 should be recognised in other comprehensive income.
- No further entries are made on 31 December 20X8, as the entity has no right to further fair value movements.
- On 5 January 20X9 the financial asset should be derecognised and the gain of £250 reclassified to profit or loss.

Answer to Interactive question 8

(a) **Statement of profit or loss and other comprehensive income (extract)**

Profit or loss for the year	**£m**
Investment income (10m × (6.5 – 5.0))	15
Dividend income (10m × 20p)	2
Transaction costs	(3)
Statement of financial position (extract)	
Investments in equity instruments (10m × 6.5) = 65	

(b) **Statement of profit or loss and other comprehensive income (extract)**

	£m
Profit or loss for the year	
Dividend income	2
Other comprehensive income	
Gain on investment in equity instruments (65 – (50 + 3))	12
Statement of financial position (extract)	
Investments in equity instruments (10m × 6.5)	65

(c) **Statement of profit or loss and other comprehensive income (extract)**

	£m
Profit or loss for the year	
Dividend income (5m × 20p)	1.0
Other comprehensive income	
Gain on revaluation of investment prior to disposal (5m × 6) – (25 + 1.5)	3.5
Gain on remaining investment in equity instruments (5m × 6.5) – (25 + 1.5)	6.0
Statement of financial position (extract)	32.5
Investments in equity instruments (5m × 6.5)	

Answer to Interactive question 9

The correct answer is:

B £80,613

The premium on redemption of the loan notes represents a finance cost. The effective rate of interest must be applied so that the debt is measured at amortised cost.

At the time of issue, the loan notes are recognised at their net proceeds of £599,800 (£600,000 – £200).

The finance cost for the year ended 31 December 20X4 is calculated as follows:

	B/f	Interest @ 12%	C/f
	£	£	£
20X3	599,800	71,976	671,776
20X4	671,776	80,613	752,389

Answer to Interactive question 10

The loans are now in Stage 3. Lifetime credit losses should continue to be recognised, and interest revenue should switch to a net interest basis, that is on the carrying amount net of allowance for credit losses.

Answer to Interactive question 11

The revenue associated with mortgage loan assets is the interest. Under IFRS 9, the variable element of the interest is accrued on a time basis, and the fixed element is reduced to reflect any initial transaction costs and to reflect a constant return on the balance outstanding.

Answer to Interactive question 12

The loan to Framlingham Inc was initially recognised on 1 May 20X8. At this point in time, 12-month expected credit losses would be recognised to reflect the probability of default within the next 12 months multiplied by total lifetime expected credit losses.

In the year ended 31 December 20X9, the terms of the loan to Framlingham Inc were modified. Southwold Co must assess whether it is a substantial change in terms. Given the delayed repayment is compensated by the continued accrual of interest and no other terms have changed, it looks likely that the initial loan will not be derecognised.

Therefore, Southwold Co must consider whether there has been a significant increase in credit risk since 1 May 20X8 and, if so, the loan moves to Stage 2 and Southwold Co recognises lifetime expected credit losses ie, the lifetime probability of default multiplied by total lifetime expected credit losses.

If interest did not accrue in the fourth and fifth years of the extended loan, Southwold Co may consider that the forbearance terms constitute a substantial change to the original terms. If so, the original loan is derecognised and a new loan recognised in Stage 1 with 12-month expected credit loss on initial recognition.

Answer to Interactive question 13

The fair value of Morden Co's promise is approximately £152,000. This is the present value of £200,000 in seven years' time at 4% (£200,000 × $1/1.04^7$).

The fair value of Merton Co's promise is approximately £116,700. This is the present value of £200,000 in seven years' time at 8% (£200,000 × $1/1.08^7$).

These two values are different, even though the amount and period are the same, due to the different risk profiles of the two companies.

Answer to Interactive question 14

In substance, the effect of the two transactions is an interest rate swap with no initial investment. This therefore meets the definition of a derivative since there is no initial net investment, an underlying variable is present and future settlement will take place. This would be the same even if no netting agreement existed because the definition of a derivative does not include a requirement for net settlement.

Answer to Interactive question 15

In Contract (1) there is an embedded derivative which should be separated from the host contract.

In Contract (2) there is an embedded derivative but this should not be separated from the host contract.

An embedded derivative should be separated from the host contract if:

- the economic characteristics and risks are not closely related to the host contract;
- a separate instrument with the same terms would meet the definition of a derivative; and
- the combined instrument has not been designated as at fair value through profit or loss.

Contract (1): The derivative embedded in this contract must be separated out, because the INR, the currency in which the contract is denominated, is not the functional currency of either party, nor is it the currency used internationally as the measure of contract prices so it is not closely related.

Contract (2): The cap is an embedded derivative that is closely related to the host debt contract because, at the time of the issuance of the debt, the cap is out-of-the-money. The embedded derivative does not require separation as it is closely related.

Answers to Self-test questions

1 Stripe Co

The asset is initially recognised at the fair value of the consideration, being £500,000. At the period end it is remeasured to £520,000.

This results in the recognition of £20,000 in other comprehensive income.

2 Trowbridge Co

Trowbridge Co has purchased the bonds to hold until maturity. The interest payments are solely payments of principal and interest on the principal amount outstanding and they are held within a business model to collect contractual cash flows. The bonds are initially measured at fair value, the purchase price of £97,327, and are subsequently measured at amortised cost.

The company has purchased bonds at discount of £(100,000 – 97,327) = £2,673. This discount is amortised over the remaining expected life of the bond using the effective interest method.

The bond amortisation schedule is as follows:

Year	Opening balance £	Interest income at EIR = 6% £	Cash received £	Closing balance £
20X8	97,327	5,840	(5,000)	98,167
20X9	98,167	5,890	(5,000)	99,057
20Y0	99,057	5,943	(105,000)	–

The closing balance at the end of each year is the amortised cost of the bonds which is recognised in the statement of financial position. This is the present value of the estimated future cash flows discounted at the original effective interest rate.

Journal entries (amounts are rounded to nearest £): 1 January 20X8

		£	£
DEBIT	Financial asset	97,327	
CREDIT	Cash		97,327

(Purchase of bond asset at discount)

31 December 20X8

		£	£
DEBIT	Financial asset	840	
DEBIT	Cash	5,000	

CREDIT Interest income (6% of £97,327)5,840 (Recognise interest income and bond amortisation based on

EIR)

CHAPTER 16

31 December 20X9

		£	£
DEBIT	Financial asset	890	
DEBIT	Cash	5,000	
CREDIT	Interest income (6% of £98,167)		5,890
	(Recognise interest income and bond amortisation based on EIR)		

31 December 20Y0

		£	£
DEBIT	Financial asset	943	
DEBIT	Cash	5,000	
CREDIT	Interest income (6% of £99,057)		5,943
	(Recognise interest income and bond amortisation based on EIR)		
DEBIT	Cash	100,000	
CREDIT	Financial asset		100,000

(Amounts received on redemption of bond at par value)

3 Purple Company

The shares are initially measured at fair value (the purchase price here) plus transaction costs:

(80,000 × £4.54) = £363,200 + (£363,200 × 1%) = £366,832

The investment is derecognised on 31 December. The fact that the same quantity of shares are repurchased the next day does not prevent derecognition as the company has no obligation to repurchase them, therefore the risks and rewards of ownership are not retained.

Immediately before derecognition a loss is recognised in other comprehensive income as the company elected to hold the investment at fair value through other comprehensive income and the investment must be remeasured to fair value at the date of derecognition (IFRS 9.3.2.12a):

(80,000 × £4.22 bid price) = £337,600 – £366,832 = £29,232 loss

The transaction costs on sale of £3,376 (£337,600 × 1%) are recognised in profit or loss.

4 Marland

The trade receivable of £128.85 million should be recognised in the statement of financial position as at 30 April 20X5 as a financial asset.

Interest on the trade receivable is £128.85m × 8% = £10.308 million. This should be recognised in the statement of profit or loss as interest income.

A loss allowance for the trade receivable should be recognised at an amount equal to 12 months' expected credit losses. Although IFRS 9, *Financial Instruments* offers an option for the loss allowance for trade receivables with a financing component to always be measured at the lifetime expected losses, Marland has chosen instead to follow the three-stage approach of

IFRS 9.

The 12-month expected credit losses are calculated by multiplying the probability of default in the next 12 months by the lifetime expected credit losses that would result from the default. Here this amounts to £18.822 million (£75.288m × 25%). Because this allowance is recognised at 1 May 20X4, the discount must be unwound by one year: £18.822m × 8% = £1.506m.

Overall adjustment:

		£m	£m
DEBIT	Finance costs (impairment of receivable) (18.822 + 1.506)	20.328	
CREDIT	Loss allowance		20.328

5 Longridge Co

Longridge Co classifies the bond at fair value through other comprehensive income (FVOCI). It recognises a loss allowance equal to 12-month expected credit losses on origination. This is recognised in profit or loss. Any subsequent increase in the loss allowance is also recognised in profit or loss. The fair value movements on the bond are recognised in other comprehensive income until sale when they are recycled to profit or loss.

1 January 20X8		**£**	**£**
DEBIT	Debt instrument – FVOCI	100,000	
CREDIT	Cash		100,000
	(Purchase of bond at FVOCI)		
DEBIT	Impairment allowance – profit or loss	1,000	
CREDIT	Other comprehensive income		1,000
	(12-month expected credit losses on orig.)		

Expected credit losses are not recognised in the statement of financial position for debt instruments measured at FVOCI, as the carrying amount of this asset should be the fair value. The impairment allowance is instead recognised in other comprehensive income as the accumulated impairment amount.

31 December 20X8		**£**	**£**
DEBIT	Cash	5,000	
CREDIT	Interest income		5,000
	(Interest income at 5% of £100,000)		
DEBIT	Impairment allowance – profit or loss	500	
CREDIT	Other comprehensive income		500
	(Increase in 1-month expected credit losses)		
DEBIT	Other comprehensive income	4,000	
CREDIT	Debt instrument – FVOCI		4,000
	(Fair value adj. to reduce asset value to £96,000)		

1 January 20X9		£	£
DEBIT	Cash	96,000	
CREDIT	Debt instrument – FVOCI		96,000
DEBIT	Loss on sale – profit or loss	2,500	
CREDIT	Other comprehensive income		2,500

(Proceeds from sale and recycling of fair value loss to profit or loss)

The gross carrying amount of the debt instrument may be reduced through use of an allowance account.

6 Gaia Bank

The credit card loans and advances are classified as amortised cost because the cash flows are solely payments of principal and interest on the principal amount outstanding, and the business model within which the balances are held is to collect the contractual cash flows rather than to sell the balances.

Under IFRS 9, the credit card loans are initially measured at fair value and are subsequently measured at amortised cost using the effective interest rate over the life of the loan.

Impairment allowances must be recognised on initial recognition of the credit card loans when they are classified in Stage 1. The impairment allowance is equal to the 12-month probability of default multiplied by lifetime expected credit losses. Expected credit losses on credit cards will be relatively high because the lending is unsecured and the loss given default is, on average, 90%.

Gaia Bank must assess at each reporting date whether the credit risk has significantly increased. It may do this on a collective basis because there is a very large number of customers (approximately 400,000 customers) but the grouping for collective assessment must be based on shared credit risk characteristics. Therefore, this could reflect the length of time a customer is past due, credit rating, past behaviour in terms of repayment, forbearance offered etc.

If credit risk has significantly deteriorated, the loan is moved to Stage 2 and lifetime expected credit losses must be recognised. The fact that the probability of default does not reduce on the credit cards as time goes on, is potentially an indicator of increased credit risk. However, spending on credit cards can vary, and the credit limit may be used to a greater or lesser extent over the product life. Behaviour on credit cards can be difficult to model because of this. It is also unclear how long customers intend to use the credit card and therefore what the expected product life is.

Gaia Bank does not appear to be defining Stage 3 accurately under IFRS 9. There is a rebuttable presumption that a loan is in default and moves to Stage 3 if payments are more than 90 days past due. The expected credit losses are still recognised on a lifetime basis, but interest is calculated differently. The effective interest rate is applied to the net balance, after impairment allowances, for loans in Stage 3. Therefore Gaia Bank could be overstating its interest income in the statement of profit or loss.

7 Pike

£8 million

IAS 32.31 requires that any derivative features embedded within a compound financial instrument (such as the call option) are 'included' in the liability component. The value of the option (£3 million), which is an asset for the company as it enables it to buy back the bonds when it wants to, is deducted from the liability element of the compound instrument (£11 million).

8 Mullet

£4 million

IAS 32.31 requires that any derivative features embedded within a compound financial instrument (such as the call option) are included in the liability component. The value of the option (£1 million) is deducted from the liability element of the compound instrument (£52 million) giving a final liability element of £51 million.

The equity element is the fair value of the compound instrument (£55 million) less the liability element after taking account of the derivative (£51 million), as IAS 32.31 requires that no gain or loss should arise on initial recognition of the component elements. The equity element is therefore £4 million.

Chapter 17

Financial instruments: hedge accounting

Introduction

Learning outcomes

- Identify and explain current and emerging issues in corporate reporting
- Determine and calculate how different bases for recognising, measuring and classifying financial assets and financial liabilities can impact upon reported performance and position
- Evaluate the impact of accounting policies and choice in respect of financing decisions for example hedge accounting and fair values
- Explain and appraise accounting standards that relate to an entity's financing activities which include: financial instruments; leasing; cash flows; borrowing costs; and government grants
- Justify and conclude for a particular scenario what comprises sufficient, appropriate audit evidence
- Design and determine audit procedures in a range of circumstances and scenarios, for example identifying an appropriate mix of tests of controls, analytical procedures and tests of details
- Demonstrate and explain, in the application of audit procedures, how relevant ISAs affect audit risk and the evaluation of audit evidence

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
1	**Hedge accounting: the main points** Many entities which are exposed to various financial risks employ hedging techniques to reduce fluctuations in the value or cash flows of financial instruments.	**Approach** Hedge accounting can appear complicated, so it is essential to work through this overview to get the big picture of what hedge accounting is aiming to do. Work through the basic hedge examples. **Stop and think** Key point: hedge accounting reduces or eliminates the volatility in profit or	Hedge accounting is tested very regularly, often in a question that covers a number of other issues relating to financial instruments.	**IQ2: Simple fair value hedge** As the title suggests, this question is relatively straightforward for a difficult topic. Make sure you understand it fully before moving on.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
		loss which would arise if the items were not linked for accounting purposes.		
2	**Hedged items** Hedge accounting attempts to reflect the economic aspects of hedging in the accounting treatment of such relationships.	**Approach** Study the definition of a hedged item, then look at paragraph 2.2 to see the forms a hedged item may take. **Stop and think** Can a group of assets be a hedged item?	Where there is hedge accounting there will be a hedging instrument and a hedged item.	N/A
3	**Hedging instruments** Nearly all derivatives and some non-derivatives can be designated as a hedging instrument.	**Approach** Focus on options (section 3.3), as this is most likely to come up in the exam. **Stop and think** Purchased options, whether call options or put options, have the potential to hedge price, currency and interest rate risks and can always qualify as hedging instruments.	The most common hedging instruments you will meet in your exam are options, forwards and futures.	N/A
4	**Conditions for hedge accounting** Under IFRS 9 the hedge effectiveness criteria are principles-based and aligned with risk management activities.	**Approach** This is a short section, but you should be very familiar with the hedge accounting conditions, so take your time over it. **Stop and think** What is rebalancing?	Part of a past exam question involved a Finance Director who was unsure if hedge accounting could be applied, so familiarity with this topic could be a good source of easy marks.	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
5	**Fair value hedge** A fair value hedge is an investment position taken by a company or an investor aiming to protect the fair value of a specific asset, liability or unrecognised company commitment from risks that can affect their profit and loss accounts.	**Approach** You have been introduced to fair value hedging in the overview section. This section focuses on application and examples. **Stop and think** What would be a suitable hedging instrument to hedge changes in fair value of a fixed rate bond?	Fair value hedge accounting could be examined together with cash flow hedge accounting in a scenario where you are advising a finance director to choose between alternatives.	**IQ4: Fair value hedge** This question involves a futures contract and requires accounting with and without hedge accounting, illustrating the purpose of hedge accounting clearly.
6	**Cash flow hedge** A cash flow hedge is an investment position taken by a company or an investor aiming to offset the potential impact of a particular risk on the cash flows of an asset, liability or another sort of exposure. They are quite common among export companies or those with an international supply chain, who tend to use financial derivatives to protect their costs and revenues from exchange rate volatility.	**Approach** You met cash flow hedging in the overview section. This section focuses on application and practical examples. Key point: The part of the gain or loss arising from an effective hedge of a hedging instrument is recognised in OCI while the ineffective portion should be recognised in profit or loss. Learn the summary table in section 7.6 – it is essential for your exam. **Stop and think** What is a forecast transaction?	Questions could cover anything from the choice of cash flow hedging or fair value hedging to journal entries and adjustments of financial statements to use of cash flow hedging that is not appropriate. Entities are not always permitted a choice between fair value hedging and cash flow hedging.	**IQ7: Swap in cash flow hedge 2** This is a short question, but the answer is not obvious.
7	**Hedge of a net investment** An overseas equity investment, ie a subsidiary, associate	**Approach** Come back to this section after you have studied Chapter 21 on	Hedges of a net investment have not come up as frequently as fair value and cash flow	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
	or joint venture is hedged by a derivative or non-derivative contract. The net investment in a foreign operation under IAS 21, is the amount of the reporting entity's interest in the net assets of the operation, including any recognised goodwill.	foreign currency transactions. The treatment is similar to a cash flow hedge as regards the treatment of effective and ineffective portions. **Stop and think** Why do you think hedging might be used for an overseas equity investment?	hedges. When they have come up they tend to be poorly answered, so work through this section carefully.	
8	**Disclosures** Certain disclosures must be made separately for each type of hedge described in IFRS 9 (ie, fair value hedges, cash flow hedges and hedges of net investments in foreign operations). Cash flow hedges have extra disclosures.	**Approach** Read through and highlight. **Stop and think** Why do cash flow hedges have additional disclosures?	You are unlikely to be asked to list these disclosures, although in an auditing context you may need to verify that they have been made.	N/A
9	**IAS 39 requirements on hedge accounting** IFRS 9 is now the examinable standard, so you should focus on the IFRS 9 hedging rules. However, entities may apply the hedge accounting rules of IAS 39 to all of its hedging relationships while following the classification and measurement rules of IFRS 9.	**Approach** You should work through section 9 for an overview of what these rules are, focusing on the differences from IFRS 9. The table in section 9.3 will be useful for this. The main difference relates to the hedge effectiveness criteria. Under IFRS 9 this is principles-based and aligned with risk management activities. IAS 39, in contrast, has a	You will not be examined solely on the IAS 39 hedging rules except in overview by way of contrast with the IFRS 9 rules. No aspects of IAS 39 other than hedging will be examined.	N/A There are no interactive questions just on the IAS 39 rules, but you can test yourself using the table in section 9.3 by covering up the IAS 39 column.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
		quantitative hedge effectiveness test under which hedge effectiveness must fall in the range 80%–125%. **Stop and think** Why would companies apply the IAS 39 rules?		
10	**Audit focus: fair value** This section applies more broadly than just to financial instruments and fair value hedging. Fair value is a key issue to investment property, pension costs, share-based payments and many other areas of financial accounting.	**Approach** Read carefully and consider why auditing fair value might be more risky than historical cost. **Stop and think** Professional scepticism is needed.	Any of the areas in the left-hand column could give rise to a question in which fair value must be considered in the audit process.	N/A
11	**Auditing financial instruments** The key issue when auditing financial instruments is risk, in particular credit risk and market risk.	**Approach** Work through section 11.1.2 very carefully, especially the section on assessing and responding to the risk of material misstatement. **Stop and think** How might valuation of financial instruments be tested?	Risk is likely to feature in any audit/integrated questions on financial instruments.	**IQ14: Convertible debenture** This is a short 'issues' and 'procedures' question.
12	**Auditing derivatives** Derivatives are risky instruments and much can go wrong. An understanding of the business process in derivatives trading	**Approach** Pay particular attention to section 12.1 and the worked example. **Stop and think** Derivative traders	Particular risks apply to derivatives. Risks (credit, market, legal, settlement, solvency) and controls relating to those risks have been examined.	**IQ15: Derivatives** This is a comprehensive question such as you might get as Question 3, integrating financial reporting and

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
	is necessary to audit derivatives. Adequate internal controls must be in place.	are the sort of people who thrive on risk. Check out Nick Leeson.		auditing. The audit part is mainly concerned with risk, but also with the audit of IFRS 7 disclosures.

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Hedge accounting: the main points

Section overview

Pay particular attention to this first section, as it contains the main points you need to know.

1.1 Introduction

In earlier levels of your study for the ACA qualification, such as Financial Management, you have covered the way hedging is an important means by which a business can **manage the risks** it is exposed to.

As an example, a manufacturer of chocolate can fix now the price at which it buys a specific quantity of cocoa beans at a predetermined future date by arranging a forward contract with the cocoa beans producer.

The forward price specified in the forward contract may be higher or lower than the spot price at the time the contract is agreed, depending on seasonal and other factors. But by agreeing the forward contract both the manufacturer and the producer have removed the risk they otherwise would face of unfavourable price movements (price increases being unfavourable to the chocolate manufacturer and price decreases unfavourable to the cocoa beans producer) between now and the physical delivery date. Equally, they have removed the possibility of favourable price movements (price decreases being favourable to the chocolate manufacturer and price increases favourable to the cocoa beans producer) over the period.

Another way of achieving the same effect would be for the chocolate manufacturer to purchase cocoa bean futures on a recognised trading exchange. On the delivery date the manufacturer would close out the futures in the futures market and then buy the required quantity in the spot market. The profit/(loss) on the futures transaction should offset the increase/(decrease) in the spot price over the period.

Hedge accounting is the accounting process which reflects in financial statements the commercial substance of hedging activities. It results in the gains and losses on the linked items (eg, the purchase of coffee beans and the futures market transactions) being recognised in the same accounting period and in the same section of the statement of profit or loss and other comprehensive income ie, both in profit or loss, or both in other comprehensive income.

Hedge accounting reduces or eliminates the volatility in profit or loss which would arise if the items were not linked for accounting purposes.

> **Tutorial note**
>
> The forward contract is a derivative. Without hedge accounting, the profit/(loss) in the futures market would be recognised as the contract is remeasured to fair value at each reporting date, but the increased/(decreased) cost of the cocoa beans would be recognised at the later date when the chocolate is sold. Both would be recognised in profit or loss, but possibly in different accounting periods.

In the previous chapter the point was made that financial assets should be classified or designated at the time of their initial recognition, not at any later date. This is to prevent businesses making classifications or designations with the benefit of hindsight so as to present figures to their best advantage. Similarly, hedge accounting is only permitted by IFRS 9, *Financial Instruments* if the hedging relationship between the two items (the cocoa beans and the futures contract in the above example) is designated at the inception of the hedge. Designation is insufficient by itself; there must be formal documentation, both of the hedging relationship and of management's objective in undertaking the hedge.

1.1.1 IFRS 9

IFRS 9 provides guidance relating to hedging and allows hedge accounting where there is a designated hedging relationship between a hedging instrument and a hedged item. It is prohibited otherwise. **Hedge accounting is therefore not mandatory.**

1.1.2 IAS 39

The IASB currently allows an **accounting policy choice** to apply either the IFRS 9 hedging model or the IAS 39 model, with an additional option to use IAS 39 for macro hedging (currently a separate project) if using IFRS 9 for general hedge accounting (IFRS 9.7.2.21).

For this reason, the IAS 39 rules are covered in overview in section 9. However, **IFRS 9 is the examinable standard. For examination purposes you only need an awareness of the differences between IAS 39 and IFRS 9 with regard to hedging.**

1.2 Overview

In simple terms the main components of hedge accounting are as follows:

(a) The **hedged item** is an asset, a liability, a firm commitment (such as a contract to acquire a new oil tanker in the future) or a forecast transaction (such as the issue in four months' time of fixed rate debt) which exposes the entity to risks of fair value/cash flow changes. The hedged item generates the risk which is being hedged.

(b) The **hedging instrument** is a derivative or other financial instrument whose fair value/cash flow changes are expected to offset those of the hedged item. The hedging instrument reduces/eliminates the risk associated with the hedged item.

(c) There is a **designated relationship** between the item and the instrument which is documented.

(d) At inception the hedge must be expected to be **highly effective** and it must turn out to be highly effective over the life of the relationship.

(e) To qualify for hedging, the changes in fair value/cash flows must have the **potential to affect profit or loss**.

(f) There are two main types of hedge:

1. The **fair value hedge**: the gain and loss on such a hedge are recognised in profit or loss.
2. The **cash flow hedge**: the gain and loss on such a hedge are initially recognised in other comprehensive income and subsequently reclassified to profit or loss.

Notes

1 The key reason for having the two types of hedge is that profits/losses are initially recognised in different places.

2 In some circumstances the entity can choose whether to classify a hedge as a fair value or a cash flow hedge.

3 There is a third type of hedge: the **hedge of a net investment** in a foreign operation, such as the hedge of a loan in respect of a foreign currency subsidiary. This is accounted for similarly to cash flow hedges.

1.3 Effectiveness of the hedge

The effectiveness of the hedge is measured as the extent to which the change in the hedging instrument offsets the change in the hedged item. IFRS 9 has three **hedge effectiveness tests,** which will be covered in more detail later.

Note: Here are three definitions you may need for the illustration that follows.

Definitions

Forward contract: A commitment to undertake a future transaction at a set time and at a set price.

Future: This represents a **commitment** to an **additional transaction** in the future that limits the risk of existing commitments.

Option: This represents a commitment by a seller to undertake a future transaction, where the buyer has the option of not undertaking the transaction.

Worked example: Basic hedging 1

1 January

On 1 January the price (the spot price) of a consignment of cocoa beans is £1,000.

You know you will need to buy a consignment of cocoa beans on 28 February, as they will be needed to fulfil a customer order. You are afraid that the price of cocoa beans will rise significantly between 1 January and 28 February.

You therefore contract with a cocoa beans supplier to buy a consignment of cocoa beans at £1,050 on 28 February.

28 February

The price of a consignment of cocoa beans is now £1,100.

You nevertheless can hold the supplier to the forward contract and can buy the cocoa beans at £1,050.

However, if the market had not behaved as predicted and the price of cocoa beans was £980 on 28 February, you would still be obliged to buy the cocoa beans at the price of £1,050.

Similarly, if the customer had pulled out of the transaction, you would still have to buy the consignment of cocoa beans and dispose of them as best you could.

Hedging deals with the bad news you do not expect! 1 January

On 1 January the price (the spot price) of a consignment of cocoa beans is £1,000.

You have already agreed to buy a consignment of cocoa beans for £1,200 on 28 February, which means you appear to be at risk of paying too much for the cocoa beans.

You buy a three-month cocoa futures contract at £1,100 that expires on 31 March. This means you are committing to buying an additional consignment of cocoa beans, not at today's spot price, but at the futures price of £1,100. £1,100 represents what the market thinks the spot price will be on 31 March.

28 February

You buy the consignment of cocoa beans at £1,200.

You are still committed to buying the consignment at £1,100 on 31 March, but that will mean that you have two consignments of cocoa beans rather than just the one you need. You therefore sell the futures contract you bought on 1 January to eliminate this additional commitment. The futures contract is now priced at £1,233, as the market now believes that £1,233 will be the spot price on 31 March.

Because you have sold the contract for more than the purchase price, you have made a gain on the futures contract of £1,233 – £1,100 = £133. This can be set against the purchase you made.

Net cost = £1,200 – £133 = £1,067; the cost of paying more for the cocoa beans has been offset by the profit made on the futures contract.

1 January

On 1 January the price (the spot price) of a consignment of cocoa beans is £1,000.

You know you will need to buy a consignment of cocoa beans on 28 February, as they will be needed to fulfil a customer order. You think it is likely that the price of cocoa beans will rise significantly between 1 January and 28 February, but you believe that with current market uncertainty, the price of cocoa beans could even fall.

You therefore take out an option to buy cocoa beans at £1,050 on 28 February. Because you are being given the privilege of choosing whether or not to fulfil the option contract, you have to pay a premium of £30.28 February.

Requirements

1 What if the price of the cocoa beans has now risen to £1,100?

2 What if the price of cocoa beans has fallen to £980? You could let the option contract lapse and buy cocoa beans at £980.

3 What if your customer pulls out of the contract?

Solution

1 You can hold the supplier to the option contract and buy the cocoa beans at £1,050. Total cost = 1,050 + 30 = £1,080.

2 Total cost = 980 + 30 = £1,010.

3 You would not have to buy the cocoa beans and the only cost to you will be the premium of £30.

Worked example: Basic hedging 2

Red, whose functional currency is the pound (£), has invested €4.75 million in purchasing a majority shareholding in Blue. The investment in Blue is entirely financed by a loan in euros. The directors of Red decide to designate the loan as a hedging instrument and the investment as the related hedged item.

Requirement

Describe the accounting treatment of any gains or losses arising on the investment and the loan, assuming that the hedging relationship meets all the conditions required by IFRS 9, *Financial Instruments* to qualify for hedge accounting.

Solution

The transaction entered into by Red is a hedging transaction of a net investment in a foreign entity. The loan is the hedging instrument and the investment in Blue is the hedged item.

As the loan has been designated as the hedging instrument at the outset, and the transaction meets the hedging criteria of IFRS 9, the exchange movements in both items should be recognised in other comprehensive income. Any ineffective portion of the hedge should be recognised in profit or loss for the year.

Below are two simple illustrative examples of accounting for a fair value hedge and accounting for a cash flow hedge. The definitions and rules for a fair value hedge and a cash flow hedge are covered in greater detail in sections 5 and 6 of this chapter.

1.4 Accounting for a simple fair value hedge

On 1 August 20X5, an entity owned 50,000 litres of vegetable oil which had cost it £5 per litre and which had a selling price (spot price = fair value) of £6 per litre. The entity was concerned that the fair value might fall over the next three months, so it took out a three-month future to sell at £6 per litre. On 31 October the spot price of the oil had fallen to £5.60. On that date the entity closed out its future and sold its inventory, both transactions being at the spot price.

The sale of 50,000 litres at £5.60 generates revenue of £280,000; deducting the cost of £250,000, the profit recognised in profit or loss should be £30,000.

The entity also makes a profit of £0.40 (£6.00 – £5.60) per litre in the futures market, so on 50,000 litres a profit of £20,000 should be recognised in profit or loss.

Subject to any futures market transaction costs, the entity has protected itself against a fall in fair value below the £6 fair value at 1 August 20X5.

1.5 Accounting for a simple cash flow hedge

On 1 November 20X5 an entity, whose functional currency is the pound (£), entered into a contract to sell goods on 30 April 20X6 for $300,000. In fixing this dollar ($) price it worked on the basis of the spot exchange rate of $1.50 = £1, so that revenue would be £200,000. To ensure it received £200,000, on 30 June 20X6 the entity took out a six-month future to sell $300,000 for £200,000.

On 31 December 20X5 (which is the company's reporting date) an equivalent futures contract traded at a value of £18,182. This may be taken as an acceptable approximation to fair value. The future was therefore worth £18,182 and the entity recognised that amount as a financial asset and as a profit in other comprehensive income.

On 30 April 20X6, the spot exchange rate was $1.75 = £1 and the future was worth £28,571 (£200,000 – £(300,000/1.75)). The entity closed out its future position at the then spot price and sold the goods. The accounting entries should be:

DEBIT	Customer £(300,000/1.75)	£171,429	
DEBIT	Financial asset (28,571 – 18,182)	£10,389	
DEBIT	Other comprehensive income (Reclassification of gain to profit or loss)	£18,182	
CREDIT	Revenue		£200,000

The customer account and the financial asset are then cleared by cash receipts. Note that revenue is measured at the amount fixed as a result of the hedging transaction.

Interactive question 1: Simple derivative and hedging

BCL entered into a forward contract on 31 July 20X0 to purchase $2 million at a contracted rate of
£1: $0.64 on 31 October 20X0. The contract cost was nil. BCL prepares its financial statements to 31 August 20X0. At 31 August 20X0, an equivalent contract for the purchase of $2 million could be acquired at a rate of £1 : $0.70.

Requirements

1.1 Explain how this financial instrument should be classified and prepare the journal entry required for its measurement as at 31 August 20X0.

1.2 Assume now that the instrument described above was designated as a hedging instrument in a cash flow hedge, and that the hedge was 100% effective.

(a) Explain how the gain or loss on the instrument for the year ended 31 August 20X0 should now be recorded and why different treatment is necessary.

(b) Prepare an extract of the statement of profit or loss and other comprehensive income for BCL for the year ended 31 August 20X0, assuming the profit for the year of BCL was £1 million, before accounting for the hedging instrument.

See **Answer** at the end of this chapter.

Interactive question 2: Simple fair value hedge

VB acquired 40,000 shares in another entity, JK, in March 20X3 for £2.68 per share. An irrevocable election was made under IFRS 9 to record changes in fair value in other comprehensive income. The shares were trading at £2.96 per share on 31 July 20X3. Commission of 5% of the value of the transaction is payable on all purchases and disposals of shares.

Requirement

(a) Prepare the journal entries to record the initial recognition of this financial asset and its subsequent measurement at 31 July 20X3 in accordance with IFRS 9, *Financial Instruments*.

(b) The directors of VB are concerned about the value of VB's investment in JK and, in an attempt to hedge against the risk of a fall in its value, are considering acquiring a derivative contract. The directors wish to use hedge accounting in accordance with IFRS 9.

Requirement

Discuss how both the investment in equity instruments and any associated derivative contract would be subsequently accounted for, assuming that the criteria for hedge accounting were met, in accordance with IFRS 9.

See **Answer** at the end of this chapter.

2 Hedged items

Section overview

This section deals with detailed issues related to hedged items in a hedging relationship.

Definitions

Hedged item: An asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that:

- exposes the entity to risk of changes in fair value or future cash flows; and
- is designated as being hedged.

Firm commitment: A binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.

Forecast transaction: An uncommitted but anticipated future transaction.

Note: Neither firm commitments nor forecast transactions are normally recognised in financial statements. As is explained in more detail in a later part of this chapter, it is only when they are designated as hedged items that they are recognised.

2.1 Financial risks

Hedged items as defined above are **exposed to a variety of risks** that affect the value of their fair value or cash flows. For hedge accounting, these risks **need to be identified** and **hedging instruments which modify the identified risks** selected and designated. The risks for which the above items can be hedged are normally classified as follows:

- Market risk

Which can be made up of:

- price risk
- interest rate risk
- currency risk

- Credit risk
- Liquidity risk

IFRS 9 allows for a portion of the risks or cash flows of an asset or liability to be hedged. For example, the hedged item may be as follows:

- Oil inventory (which is priced in \$) for a UK company, where the fair value of foreign currency risk is being hedged but not the risk of a change in \$ market price of the oil
- A fixed rate liability, exposed to foreign currency risk, where only the interest rate and currency risk are hedged but the credit risk is not hedged

2.2 Nature of hedged items

In this section we discuss some of the **key aspects** of the definition of a hedged item.

(a) The hedged item can be:

  (1) a single asset, liability, unrecognised firm commitment, highly probable forecast transaction or net investment in a foreign operation;

  (2) a group of assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations with similar risk characteristics; or

  (3) a portion of a portfolio of financial assets or financial liabilities which share exposure to interest rate risk. In such a case, the portion of the portfolio that is designated as a hedged item is a hedged item with regard to interest rate risk only.

(b) Assets and liabilities designated as hedged items can be **either financial or non-financial items**.

  (1) **Financial items** can be designated as hedged items for the risks associated with only a **portion** of their cash flows or fair values. So a fixed rate liability that is exposed to foreign currency risk can be hedged in respect of currency risk, leaving the credit risk not hedged.

  (2) IFRS 9 allows **separately identifiable and reliably measurable risk components of non-financial items** to be designated as hedged items.

(c) **Unrecognised** assets and liabilities **cannot be designated as hedged items**. So unrecognised intangibles cannot be hedged items.

(d) **Only** assets, liabilities, firm commitments or highly probable transactions that involve a party external to the entity can be **designated as hedged items**. The effect is that hedge accounting can be applied to transactions between entities or segments in the same group only in the individual or separate financial statements of those entities or segments, and not in the consolidated financial statements.

(e) As an exception, an **intra-group monetary item** qualifies as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains and losses that are not eliminated on consolidation.

Context example: Intra-group hedge

The functional currency of Anson Co and its subsidiary Benson Co are the pound (£) and dollar ($) respectively. Benson Co sells $100 of goods to Anson Co just before the year end. The amount remains unsettled at the year end.

While the intercompany balances are eliminated on consolidation, the exchange differences that arise in Anson Co from the retranslation of the monetary liability are not eliminated on consolidation. Hence, the intercompany monetary item can be designated as a hedged item in a foreign currency hedge.

2.3 Designation of a group of assets as hedged items

IFRS 9 permits the designation of a group of assets as a hedged item provided that the following
conditions are met.

(a) It consists of items which are individually eligible as hedged items.

(b) The items in the group are managed together on a group basis for risk management purposes.

(c) In the case of a cash flow hedge of a group of items whose variabilities in cash flows are not expected to be approximately proportional to the overall variability in cash flows of the group:

  (1) it is a hedge of foreign currency risk; and

  (2) the designation of that net position specifies the reporting period in which the forecast transactions are expected to affect profit or loss, as well as their nature and volume.

For a hedge of a net position whose hedged risk affects different line items in the statement of profit or loss and other comprehensive income, any hedging gains or losses in that statement are presented in a separate line from those affected by the hedged items.

(IFRS 9.6.6.4)

Worked example: Group of assets

An entity constructs a portfolio of shares to replicate a stock index and uses a put option on the index to protect itself from fair value losses.

Requirement

Can the portfolio of shares be designated as a hedged item?

Solution

The portfolio **cannot** be designated as a hedged item. Similar financial instruments should be aggregated and hedged as a group only if the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group. In the scenario above, the change in the fair value attributable to the hedged risk for each individual item in the group (individual share prices) is not expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group; even if the index rises, the price of an individual share may fall.

2.4 Hedging an overall net position

IFRS 9 allows hedge accounting to be applied to **groups of items and net positions** if the group consists of individually eligible hedged items and those items are managed together on a group basis for risk management purposes.

For a **cash flow hedge of a group of items**, if the variability in cash flows is not expected to be approximately proportional to the group's overall variability in cash flows, the **net position is eligible** as a hedged item only **if it is a hedge of foreign currency risk**. In addition, the designation must specify the reporting period in which forecast transactions are expected to affect profit or loss, including the nature and volume of these transactions.

2.5 Risk components of non-financial items

IFRS 9 allows **separately identifiable and reliably measurable risk components of non-financial items**
to be designated as hedged items.

2.6 Components

IFRS 9 allows a component that is a proportion of an entire item or a **layer component** to be designated as a hedged item in a hedging relationship. A layer component may be specified from a defined, but open, population or a defined nominal amount. For example, an entity could designate 20% of a fixed rate bond as the hedged item, or the top layer of £20 principal from a total amount of
£100 (defined nominal amount) of fixed-rate bond. It is necessary to track the fair value movements of the nominal amount from which the layer is defined.

2.7 Aggregate exposure

IFRS 9 allows **aggregated exposures** that include a derivative to be an **eligible hedged item**.

Context example: Aggregated exposure as hedged item

Zeta Bank has a fixed rate foreign currency loan which exposes it to both foreign exchange rate risk and fair value risk due to changes in interest rates. The bank enters into a cross-currency interest rate swap to eliminate the foreign exchange risk and fair value risk due to changes in interest rates but is now exposed to variable functional currency interest payments.

Zeta Bank may hedge the aggregated exposure (foreign currency loan + cross-currency interest rate swap) by using, for example, a pay fixed and receive floating interest rate swap in its own functional currency.

2.8 Equity investments at fair value through other comprehensive income

IFRS 9 allows an entity to classify equity investments not held for trading, at fair value through other comprehensive income through an irrevocable option on origination of the instrument. The gains and losses are recognised in other comprehensive income and never reclassified to profit or loss.

IFRS 9 allows these equity investments at fair value through other comprehensive income to be designated as hedged items. In this case, both the effective and ineffective portion of the fair value changes in the hedging instruments are recognised in other comprehensive income.

2.9 Fair value designation for credit exposures

Many banks use credit derivatives to manage credit risk exposures arising from their lending activities. The hedges of credit risk exposure allow banks to transfer the risk of credit loss to a third party. This may also reduce regulatory capital requirements.

IFRS 9 allows **credit exposure or part of the credit exposure** to be measured at **fair value through profit or loss** if an entity uses a **credit derivative** measured at **fair value through profit or loss** to manage the credit risk of all, or part of, the credit exposure. In addition, an entity may make the designation at initial recognition or subsequently, or while the financial instrument is unrecognised.

Interactive question 3: Credit derivative and credit exposures

Excel Bank extends a fixed rate loan commitment of £1 million to a customer. The bank's risk management strategy is to hedge the credit risk exposure of any individual loan commitment to the extent that it exceeds £500,000. As a result, Excel Bank enters into a credit default swap of £500,000 in relation to this loan commitment to the customer.

Requirement

Explain the accounting for the credit default swap and the loan commitment under IFRS 9. See

Answer at the end of this chapter.

2.10 Firm commitments as hedged items

Firm commitments (as defined above) are the result of legally binding contracts which normally specify penalties for non-performance. A firm commitment can be a hedged item.

2.11 Forecast transactions as hedged items

A forecast transaction (as defined above) **qualifies as a hedged item only if the transaction is highly probable**. Examples of forecast transactions that qualify as a hedged item include the following:

(a) The anticipated issue of fixed rate debt. This can be recognised as a hedged item under a cash flow hedge of a highly probable forecast transaction that will affect profit or loss.

(b) Expected, but not contractual, future foreign currency revenue streams, provided that the revenues are highly probable. A hedge of an anticipated sale can qualify as a cash flow hedge.

Context example: Forecast transaction

An airline may use models based on past experience and historical economic data to project its revenues in various currencies. If it can demonstrate that forecast revenues for a period of time into the future in a particular currency are highly probable, it may designate a currency borrowing as a cash flow hedge of the currency risk of the future revenue stream. The portion of the gain or loss on the borrowing that is determined to be an effective hedge is recognised in other comprehensive income until the revenues occur.

It is unlikely that an entity can reliably predict 100% of revenues for a future year. On the other hand, it is possible that a portion of predicted revenues, normally those expected in the short term, will meet the 'highly probable' criterion.

Because forecast transactions can only be hedged under cash flow hedges, the ways to assess the probability of a future transaction are covered below under cash flow hedges.

2.12 Intra-group and intra-entity hedging transactions

It has already been noted that hedged items have to involve a party external to the entity, with the result that intra-group transactions can be designated as hedged items only in the individual or separate financial statements and not in consolidated financial statements. There are only two cases, both involving foreign exchange translation, where intra-group transactions will be recognised in the consolidated financial statements.

The first case is a result of IAS 21, *The Effects of Changes in Foreign Exchange Rates* under which foreign exchange gains and losses on an intra-group monetary asset or liability between entities with different functional currencies are not fully eliminated in the consolidated profit or loss. This is because a foreign currency monetary item represents a commitment to convert one currency into another one and exposes the reporting entity to a gain or loss through currency fluctuations.

Because such exchange differences are not fully eliminated on consolidation, they will affect profit or loss in the entity's consolidated financial statements and hedge accounting may be applied.

The second case arises because IFRS 9 permits the foreign currency risks of a highly probable forecast intra-group transaction to be designated as a hedged item in the consolidated financial statements provided the following two conditions are met.

(a) The highly probable forecast intra-group transaction is denominated in a currency other than the functional currency of the group member entering into that transaction.

(b) The foreign currency risk will affect the group's consolidated profit or loss.

Worked example: Hedging intra-group monetary items

An Australian company, whose functional currency is the Australian dollar, has forecast purchases in Japanese yen that are highly probable. The Australian entity is wholly owned by a Swiss entity that prepares consolidated financial statements (which include the Australian subsidiary) in Swiss francs. The Swiss parent entity enters into a forward contract to hedge the change in yen relative to the Australian dollar.

Requirement

Explain whether the hedge can qualify for hedge accounting in the Swiss entity's consolidated financial statements.

Solution

The hedge can qualify for hedge accounting. Since the Australian entity did not hedge the foreign currency exchange risk associated with the forecast purchases in yen, the effects of exchange rate changes between the Australian dollar and the yen will affect the Australian entity's profit or loss and, therefore, would also affect consolidated profit or loss. IFRS 9 does not require the operating unit that is exposed to the risk being hedged to be a party to the hedging instrument.

3 Hedging instruments

Section overview

This section considers in detail the financial instruments that can be designated as hedging instruments for hedge accounting purposes.

3.1 Hedging instruments

Contracts that can be designated as hedging instruments include:

- derivatives; and
- non-derivative financial assets or liabilities measured at fair value through profit or loss (with the exception of financial liabilities designated at fair value through profit or loss, for which changes in fair value attributable to credit risk are presented in other comprehensive income).

For the hedge of a foreign currency risk, the foreign currency risk component of a non-derivative financial asset or liability may be designated as a hedging instrument, provided that it is not an investment in an equity instrument measured at fair value through comprehensive income by election.

An implication of this definition is that financial assets and liabilities whose fair value cannot be reliably measured cannot be designated as hedging instruments.

An entity may exclude the following from hedging relationships:

- Time value of purchased options
- Forward element of forward contracts and foreign currency basis spreads

3.2 Derivatives

Any derivative financial instrument, with the exception of written options to which special rules apply, **can be designated as a hedging instrument**. It is important to note that the fair value of derivative instruments correlates highly with that of the underlying.

3.3 Options

Options provide a more flexible way of hedging risks compared to other derivative instruments such as forwards, futures and swaps, because they give to the holder the choice as to whether or not to exercise the option.

When an entity purchases a put option, it buys the right to sell the underlying at the strike price. If the price of the underlying falls below the strike price, the entity exercises its option and receives the strike price; it has protected the value of its position. Similarly, if an entity needs to buy an asset in the future, it can purchase a call option on the asset that gives the entity the right to purchase the asset at the strike price, protecting it from a rise in the price of the asset in the future.

The difference between the purchased option and a forward contract is that under a forward contract the entity is obliged to buy or sell at the strike price, whereas under a purchased option it has the right, but not the obligation, to buy or sell at the strike price.

Purchased options, whether call options or put options, have the potential to hedge **price**, **currency** and **interest rate risks** and can always qualify as hedging instruments.

Examples of purchased options include options on equities, options on currencies and options on interest rates. An interest rate floor is achieved through a put option on an interest rate, and an interest rate cap is achieved through a call option on an interest rate.

In **IFRS 9**, an entity may **designate only the change in intrinsic value** of a purchased option as the hedging instrument in a fair value or cash flow hedge. The change in **fair value of the time value of the option** is recognised in **other comprehensive income** to the extent it relates to the hedged item. This change in IFRS 9 makes options more attractive as hedging instruments.

The method used to reclassify the amounts from equity to profit or loss is determined by whether the hedged item is transaction-related or time period-related.

The time value of a purchased option relates to **a transaction-related hedged item** if the nature of the hedged item is a transaction for which the time value has the character of costs of the transaction. For example, future purchase of a commodity or non-financial asset.

The **change in fair value of the time value of an option (transaction-related hedged item)** is accumulated in other comprehensive income over the term of the hedge, to the extent it relates to the hedged item. It is then treated as follows:

- If the hedged item results in the recognition of a **non-financial asset or liability or firm commitment** for a non-financial asset or liability, the amount accumulated in equity is removed and included in the **initial cost or carrying amount** of the asset or liability.
- For **other hedging relationships**, the amount accumulated in equity is **reclassified to profit or loss** as a reclassification adjustment in the period(s) in which the hedged expected cash flows affect profit or loss.

The time value of a purchased option relates to a time period-related hedged item if the following apply:

(a) The nature of the hedged item is such that the time value has the character of the cost for obtaining protection against a risk over a particular time period.

(b) The hedged item does not result in a transaction that involves the notion of a transaction cost.

The **change in fair value of the time value of an option (time period-related hedged item)** is accumulated in other comprehensive income over the term of the hedge, to the extent it relates to the hedged item. The time value of the option at the date of designation is amortised on a straight- line or other systematic and rational basis, and the amortisation amount is reclassified to profit or loss as a reclassification adjustment.

4 Conditions for hedge accounting

Section overview

Hedge accounting is permitted in certain circumstances, provided the hedging relationship is clearly defined, measurable and actually effective.

4.1 Hedge accounting conditions

Before a hedging relationship qualifies for hedge accounting, all of the following conditions must be met:

(a) The hedging relationship must consist only of eligible hedging instruments and eligible hedged items.

(b) At the inception of the hedge, there must be formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. Documentation must include identification of the hedged item, the hedging instrument, the nature of the hedged risk and how the entity will assess whether the hedging relationship meets the hedge effectiveness requirements (including its analysis of the sources of hedge ineffectiveness and how it determines the hedge ratio).

(c) The hedging relationship meets all of the hedge effectiveness requirements:

    (1) An economic relationship exists between the hedged item and the hedging instrument ie, the hedging instrument and the hedged item are expected to have offsetting changes in value;

(2) The effect of credit risk does not dominate the value changes ie, the value changes due to credit risk are not a significant driver of the value changes of either the hedging instrument or the hedged item; and

(3) The hedge ratio of the hedging relationship (quantity of hedging instrument vs quantity of hedged item) is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item. (IFRS 9.6.4.1)

Definition

Hedge ratio: The relationship between the quantity of the hedging instrument and the quantity of the hedged item in terms of their relative weighting.

IFRS 9 requires that the hedge ratio used for accounting purposes is the same as that used for risk management purposes. This ensures that amounts are not manipulated in order to achieve a particular accounting outcome.

Professional skills focus: Applying judgement

The hedge effectiveness criteria are an example of an area where judgement must be applied. Judgement is generally needed where risk management is concerned, but having arbitrary percentage ranges, as IFRS 9's predecessor did, does not make the criteria any more precise, and could be misleading.

Context example: Hedge ratio

CoffeeBar plc buys coffee in a part-processed state, prior to the milling stage. As a result, it pays a discounted price compared to that for fully processed coffee. The price of fully processed coffee on the commodities market is on average 1.7 times the raw material price that CoffeeBar pays.

Therefore CoffeeBar uses a notional 1,000 pounds of forward contract for the commodity to hedge a highly probable forecast purchase of 1,700 pounds of raw material. The hedge ratio is therefore 1 : 1.7.

4.2 Rebalancing

Rebalancing refers to adjustments to the designated quantities of the hedged item, or the hedging instrument of an already existing hedging relationship for the purpose of maintaining a hedge ratio that complies with the hedge. This may be achieved by increasing or decreasing the volume of either hedged item or hedging instrument.

The standard requires rebalancing to be undertaken if the risk management objective remains the same, but the hedge effectiveness requirements are no longer met. Where the risk management objective for a hedging relationship has changed, rebalancing does not apply and the hedging relationship must be discontinued.

Context example: Rebalancing

Continuing with the previous example, assume that the relationship between the commodity price and raw material price changes over Year 1 such that by the end of the year the commodity price has decreased to an average 1.3 times the raw material price. In this case, management of the reporting entity might reset the hedge ratio to 1 : 1.3. Therefore to rebalance the hedging relationship management can either:

- decrease the raw material that forms the hedged item so that the hedged item is 1.31 pounds (1/1.3 × 1.7); or
- increase the commodity that forms the hedging instrument, so that the hedging instrument is 1.3 pounds.

5 Fair value hedge

Section overview

The application of fair value hedge accounting is discussed through a number of practical examples.

5.1 Fair value hedges

A fair value hedge is a hedge of an entity's exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a part thereof, that is **attributable to a particular risk and could affect profit or loss**. Examples of fair value hedges include the hedge of exposures to changes in fair value of fixed rate debt using an interest rate swap and the use of an oil forward contract to hedge movements in the price of oil inventory.

5.1.1 Examples of fair value hedging

Hedged item	Risk exposure	Type of risk	Example of hedging instrument
Commodity inventory	Change in value due to changes in the price of commodity	Market risk (price risk)	Forward contract
Equities	Change in the value of the investments due to changes in the price of equity	Market risk (price risk)	Purchase put option
Issued fixed rate bond	Change in the value of the bond as interest rates change	Market risk (interest rate risk)	Interest rate swap
Purchase of materials denominated in foreign currency in three months	Depreciation of the local currency and increase in the cost of material	Market risk (foreign currency)	Forward contract

5.1.2 Hedge accounting and risk reduction

IFRS 9 does not require that in order for a hedging relationship to qualify for hedge accounting, it should lead to a reduction in the overall risk of the entity. A hedging relationship that satisfies the conditions for hedge accounting may be designed to protect the value of a particular asset. The following example illustrates the point.

Worked example: Qualification for hedge accounting

An entity has a fixed rate financial asset and a fixed rate financial liability, each having the same principal amount. Under the terms of the instruments, interest payments on the asset and liability occur in the same period and the net cash flow is always positive because the interest rate on the asset exceeds the interest rate on the liability. The entity wishes to hedge the financial asset and enters into an interest rate swap to receive a floating interest rate and pay a fixed interest rate on a notional amount equal to the principal of the asset. It designates the interest rate swap as a fair value hedge of the fixed rate asset.

Requirement

Does the hedging relationship qualify for hedge accounting even though the effect of the interest rate swap on an entity-wide basis is to create an exposure to interest rate changes that did not previously exist?

Solution

Yes. IFRS 9 does not require risk reduction on an entity-wide basis as a condition for hedge accounting. Exposure is assessed on a transaction basis and, in this instance, the asset being hedged has a fair value exposure* to interest rate increases that is offset by the interest rate swap.

* The fair value of a loan is the present value of the cash flows. A fixed rate loan has constant cash flows so the fair value is directly affected by a change in the discount rate (ie, the market interest rate).

5.2 Fair value hedge accounting

In a fair value hedge:

(a) the hedged item is a recognised asset or liability. This is re-measured to fair value at the end of the reporting period and the gain or loss on the hedged item attributable to the **hedged risk** is **recognised in profit or loss**;

(b) the hedging instrument is a derivative. The **gain or loss** resulting from **re-measuring** the hedging instrument at fair value is also **recognised in profit or loss**;

(c) if the hedged item is an **equity investment measured at fair value through OCI**, the gains and losses on the hedged investment and hedging instrument are both recognised in other comprehensive income rather than profit or loss; and

(d) if the hedged item is an **unrecognised firm commitment**, the cumulative change in the fair value of the hedged item after it has been designated as a hedged item is recognised as an asset or liability with a corresponding amount recognised in profit or loss.

Context example: Gain or loss on hedged item recognised in profit or loss

At 1 November 20X5, an entity held inventory with a cost of £400,000 and a fair value of £600,000. The entity acquired a derivative to hedge against a fall in the fair value of its inventory below £600,000. At its year end two months later, the fair value of its inventory had fallen by £20,000 and the derivative it holds had a value of £20,000.

The journals required at the year end are as follows.

DEBIT	Financial asset	£20,000	
CREDIT	Profit or loss		£20,000

To recognise the gain on the derivative hedging instrument

DEBIT	Profit or loss	£20,000	
CREDIT	Inventories		£20,000

To adjust the carrying amount of inventories by the loss in its fair value (because closing inventories reduce cost of sale, a decrease in their carrying amount increases cost of sales and reduces profit).

The effect is as follows:

(a) The loss on the hedged item has been recognised in profit or loss.

(b) There is a nil net effect in profit or loss, because the hedge has been 100% effective.

(c) Inventories are carried at £380,000. This is neither cost (£400,000) nor fair value (£580,000).

(d) The entity has been protected against loss of profit. If it had sold the inventory on 1 November, it would have made a profit of £200,000 (£600,000 – £400,000); if it sells the inventory on 1 January 20X6, it will make a profit of £200,000 (£580,000 – £380,000).

Interactive question 4: Fair value hedge

A company owns inventories of 40,000 gallons of oil which cost £800,000 on 1 December 20X3.

In order to hedge the fluctuation in the market value of the oil, on 1 December 20X3 the company signs a futures contract to deliver 40,000 gallons of oil on 31 March 20X4 at the futures price of £22 per gallon.

The market price of oil on 31 December 20X3 is £22.25 per gallon, and the futures price at that date for delivery on 31 March 20X4 is £24 per gallon.

Assume that the IFRS 9 hedging criteria are met.

Requirements

Explain how these transactions should be accounted for at 31 December 20X3:

(a) without hedge accounting

(b) with hedge accounting

See **Answer** at the end of this chapter.

If only particular risks attributable to a hedged item are hedged, recognised changes in the hedged item's fair value unrelated to the hedged risk are recognised as normal. This means that changes in fair value of a hedged financial asset or liability that is not part of the hedging relationship would be accounted for as follows:

(a) For instruments measured at amortised cost, such changes would not be recognised.

(b) For instruments measured at fair value through profit or loss, such changes would be recognised in profit or loss in any event.

(c) For equity instruments in respect of which another comprehensive income election has been made, such changes would be recognised in other comprehensive income, as explained above. However, exceptions to this would include foreign currency gains and losses on monetary items and impairment losses, which would be recognised in profit or loss in any event.

If the fair value hedge is 100% effective (as in the above example), then the change in the fair value of the hedged item will be wholly offset by the change in the fair value of the hedging instrument and there will be no effect in profit or loss. Whenever the hedge is not perfect and the change in the fair value of the hedged item is not fully cancelled by change in the fair value of the hedging instrument, the resulting difference will be recognised in profit or loss. This difference is referred to as hedge ineffectiveness.

Worked example: Fair value hedge of inventory

On 1 July 20X6, a jewellery trader acquired 10,000 ounces of a material which it held in its inventory. This cost £200 per ounce, so a total of £2 million. The trader was concerned that the price of this inventory would fall, so on 1 July 20X6 he sold 10,000 ounces in the futures market for £210 per ounce for delivery on 30 June 20X7. On 1 July 20X6, the conditions for hedge accounting were all met, and these continued to be met throughout the hedging period.

At 31 December 20X6, the end of the trader's reporting period, the fair value of the inventory was £220 per ounce while the futures price for 30 June 20X7 delivery was £227 per ounce. On 30 June 20X7 the trader sold the inventory and closed out the futures position at the then spot price of £230 per ounce.

Requirement

Set out the accounting entries in respect of the above transactions.

Solution **Entries**

	Debit	Credit
1 July 20X6	**£**	**£**
Inventory Cash	2,000,000	
(To record the initial purchase of material)		2,000,000

At 31 December 20X6 the increase in the fair value of the inventory was £200,000 (10,000 × (£220 – £200)) and the increase in the forward contract liability was £170,000 (10,000 × (£227 – £210)). The IFRS 9 hedge accounting criteria have been met, so hedge accounting was permitted.

	Debit	Credit
31 December 20X6	**£**	**£**
Profit or loss	170,000	
Financial liability		170,000
(To record the loss on the forward contract)		
Inventories	200,000	

	Debit	Credit
31 December 20X6	**£**	**£**
Profit or loss		200,000
(To record the increase in the fair value of the inventories)		

At 30 June 20X7 the increase in the fair value of the inventory was another £100,000 (10,000 × (£230 – £220)) and the increase in the forward contract liability was another £30,000 (10,000 × (£230 – £227)).

30 June 20X7	Debit £	Credit £
Profit or loss	30,000	
Financial liability		30,000
(To record the loss on the forward contract)		
Inventories	100,000	
Profit or loss		100,000
(To record the increase in the fair value of the inventories)		
Profit or loss	2,300,000	
Inventories		2,300,000
(To record the inventories now sold)		
Cash	2,300,000	
Profit or loss – revenue		2,300,000
(To record the revenue from the sale of inventories)		
Financial liability	200,000	
Cash		200,000
(To record the settlement of the net balance due on closing the financial liability)		

Note that because the fair value of the material rose, the trader made a profit of only £100,000 on the sale of inventories. Without the forward contract, the profit would have been £300,000 (£2,300,000 – £2,000,000). In the light of the rising fair value, the trader might in practice have closed out the futures position earlier, rather than waiting until the settlement date.

5.2.1 Interest rate futures

An interest rate futures contract has interest-bearing instruments as its underlying asset. Futures contracts are available in relation to short-term interest rates in major currencies like sterling, euros, yen and Swiss francs. These derivatives can be used to gain exposure to, or hedge exposure against, interest rate movements. Three-month sterling future (short sterling) is a 90-day sterling SONIA interest rate future traded on ICE Futures Europe with the following characteristics:

Unit of trade: £500,000 (this is a notional amount on which interest effect is measured)

Quote: 100 minus interest rate

Tick size: 0.01 (smallest permitted quote movement ie, one basis point)

Tick value: £12.50 (£500,000 × 0.01% × 3/12)

The contract is cash settled ie, one party pays to the other the difference in value between the interest for three months at the rate agreed when the contract was originated and actual rate on maturity.

Note that SONIA, Sterling Overnight Index Average is a benchmark rate that replaced LIBOR in 2021.

Worked example: Fair value hedge using interest rate futures

Zeta Bank has a fixed rate financial asset of £10 million and is concerned that interest rates will increase from the current levels.

Requirement

Explain how Zeta Bank can hedge the fair value of the fixed rate financial asset of £10 million against an increase in interest rates using interest rate futures.

Solution

If interest rates increase, the fair value of the fixed rate financial asset will decrease. Zeta Bank requires a futures position that will yield profits when interest rates increase to offset this loss. It should therefore sell £(10,000,000/500,000) = 20 futures contracts. If the interest rate increases, the gain on the futures position will offset the loss on the fixed rate financial asset.

Zeta Bank should designate the futures contract as the hedging instrument and the fixed rate financial asset as the hedged item in a fair value hedge. If the IFRS 9 conditions for hedge accounting are met, the fair value movements on the futures contract and the financial asset will be recognised and offset in profit or loss.

5.3 Hedging of firm commitments

The hedging of a **firm commitment** should be treated as a **fair value hedge, except** that a firm commitment with a **price fixed** in **foreign currency** may be treated as **either a fair value hedge or a cash flow hedge** of the foreign currency risk.

When an unrecognised firm commitment to acquire an asset or to assume a liability is designated as a hedged item in a fair value hedge, the accounting treatment is as follows:

(a) The **subsequent cumulative change in the fair value of the firm commitment** attributable to the hedged risk since inception of the hedge is recognised as an asset or liability with a corresponding gain or loss **recognised in profit or loss**.

(b) The **changes in the fair value of the hedging instrument** are also **recognised in profit or loss**.

(c) When the firm commitment is **fulfilled**, the initial carrying amount of the asset or liability is **adjusted** to include the cumulative change in the firm commitment that has been recognised in the statement of financial position (SOFP) under the first point above.

5.4 Discontinuing fair value hedge accounting

Fair value hedge accounting should be discontinued if the hedging instrument expires or is sold, terminated or exercised, if the criteria for hedge accounting are no longer met, or if the entity revokes the designation.

The discontinuance should be accounted for prospectively ie, the previous accounting entries are not reversed. The hedged item is not adjusted for any further changes in its fair value and adjustments already made are recognised in profit or loss over the life of the item.

6 Cash flow hedge

Section overview

The application of cash flow hedge accounting is discussed in this section through a series of practical examples.

6.1 Cash flow hedge

A cash flow hedge is a **hedge of the variability in an entity's cash flows**. The variability should be attributable to a particular risk associated with a recognised asset or liability, or a highly probable forecast transaction and **could affect profit or loss**.

Examples of cash flow hedges include the following:

(a) The use of interest rate swaps to change floating rate debt into fixed rate debt. The entity is hedging the risk of variability in future interest payments which may arise for instance from changes in market interest rates. The fixed rate protects this cash flow variability (but with the consequence that the fair value of the instrument may now vary in response to market interest movements).

(b) The use of a commodity forward contract for a highly probable sale of the commodity in future. The entity is hedging the risk of variability in the cash flows to be received on the sale, due to changes in the market price of the goods.

The hedge of foreign currency assets and liabilities using forward exchange contracts can be treated as either a fair value or a cash flow hedge. This is because movements in exchange rates change both the fair value of such assets and liabilities and ultimate cash flows arising from them. Similarly, a hedge of the foreign currency risk of a firm commitment may be designated as either a fair value or a cash flow hedge.

6.2 Forecast transaction

A forecast transaction is an uncommitted but anticipated future transaction. To qualify for cash flow hedge accounting, the forecast transaction should be:

- **specifically identifiable** as a single transaction or a group of individual transactions which share the same risk exposure for which they are designated as being hedged;
- **highly probable**. The factors to be taken into account when assessing the probability of the transaction are discussed further below; and
- with a party that is **external** to the entity.

6.2.1 Specifically identifiable

Identification of hedged forecast transaction

A forecast transaction such as the purchase or sale of the **last 15,000 units** of a product in a specified period, or as a percentage of purchases or sales during a specified period, **does not qualify as a hedged item**.

This is because the hedged forecast transaction must be identified and documented with sufficient specificity so that when the transaction occurs, it is clear whether the transaction is or is not the hedged transaction. Therefore, a forecast transaction may be identified as the sale of the first 15,000 units of a specific product during a specified three-month period, but it could not be identified as the last 15,000 units of that product sold during a three-month period because the last 15,000 units cannot be identified when they are sold. For the same reason, a forecast transaction cannot be specified solely as a percentage of sales or purchases during a period.

Documentation of timing of forecast transaction

For a hedge of a forecast transaction, the documentation of the hedge relationship that is established at inception of the hedge should identify the date on which, or time period in which, the forecast transaction is expected to occur. This is because the hedge must relate to a specific identified risk and it must be possible to measure its effectiveness reliably. In addition, the hedged forecast transaction must be highly probable.

To meet these criteria, an entity is not required to predict and document the exact date a forecast transaction is expected to occur. However, it is required to identify and document the time period during which the forecast transaction is expected to occur within a reasonably specific and generally narrow range of time from a most probable date, as a basis for assessing hedge effectiveness. To determine that the hedge will be effective, it is necessary to ensure that changes in the fair value of the expected cash flows are offset by changes in the fair value of the hedging instrument, and this test may be met only if the timing of the cash flows occur within close proximity to each other.

6.2.2 What is 'highly probable'?

The term 'highly probable' indicates a much greater likelihood of happening than the term 'more likely than not'. An assessment of the likelihood that a forecast transaction will take place is not based solely on management's intentions because intentions are not verifiable. A transaction's probability should be supported by observable facts and the attendant circumstances.

In assessing the likelihood that a transaction will occur, an entity should consider the following circumstances:

(a) The frequency of similar past transactions

(b) The financial and operational ability of the entity to carry out the transaction

(c) Substantial commitments of resources to a particular activity (for example, a manufacturing facility that can be used in the short run only to process a particular type of commodity)

(d) The extent of loss or disruption of operations that could result if the transaction does not occur

(e) The likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose (for example, an entity that intends to raise cash may have several ways of doing so, ranging from a short-term bank loan to an offering of ordinary shares)

(f) The entity's business plan

6.2.3 Further matters to consider

The length of time until a forecast transaction is projected to occur is also a factor in determining probability. Other factors being equal, the more distant a forecast transaction is, the less likely it is that the transaction would be regarded as highly probable and the stronger the evidence that would be needed to support an assertion that it is highly probable.

For example, a transaction forecast to occur in five years may be less likely to occur than a transaction forecast to occur in one year. However, forecast interest payments for the next 20 years on variable rate debt would typically be highly probable if supported by an existing contractual obligation.

In addition, other factors being equal, the greater the physical quantity or future value of a forecast transaction in proportion to the entity's transactions of the same nature, the less likely it is that the transaction would be regarded as highly probable and the stronger the evidence that would be required to support an assertion that it is highly probable. For example, less evidence generally would be needed to support forecast sales of at least 100,000 units in the next month than 950,000 units in that month when recent sales have averaged 950,000 units per month for the past three months.

A history of having designated hedges of forecast transactions and then determining that the forecast transactions are no longer expected to occur would call into question both an entity's ability to predict forecast transactions accurately and the propriety of using hedge accounting in the future for similar forecast transactions.

Professional skills focus: Applying judgement

With so many factors to consider, some of which may point to different conclusions, a considerable amount of judgement is needed in both financial reporting and auditing of probable forecast transactions.

6.3 Cash flow hedge accounting

A cash flow hedge involves hedging future cash flows. Initially therefore, only the hedging instrument (the derivative) is recognised.

The part of the gain or loss arising from an **effective** hedge of a hedging instrument is **recognised in other comprehensive income** while the **ineffective portion** of the gain or loss on the hedging instrument should **be recognised in profit or loss**.

Amounts recognised in other comprehensive income are accumulated in a cash flow hedge reserve. At a given reporting date this will be the lower of:

(a) the cumulative gain or loss on the hedging instrument from the inception of the hedge; and

(b) the cumulative change in fair value (present value) of the expected future cash flows on the hedged item from inception of the hedge.

When the separate component of equity has been adjusted to this amount, any remaining gain or loss on the hedging instrument is recognised in profit or loss.

In the period in which the hedged expected future cash flows affect profit or loss, the amount accumulated in the cash flow hedge reserve is reclassified to profit or loss with the following exception:

If the hedged transaction results in the recognition of a non-financial asset or liability, the amount accumulated in the cash flow hedge reserve is transferred to be included in the initial cost or carrying amount of the non-financial item. This is not a reclassification adjustment and does not affect the other comprehensive income of the period.

Interactive question 5: Cash flow hedge

A company enters into a hedge in order to protect its future cash inflows relating to a recognised financial asset held at amortised cost.

At inception the value of the hedging instrument was £0, but by the year end a gain of £8,800 was made when measured at market value. The corresponding loss in respect of the future cash flows amounted to £9,100 in fair value terms.

Requirement

How should the transaction be accounted for? See **Answer** at the end of this chapter.

Interactive question 6: Swap in cash flow hedge 1

An entity issues a fixed rate debt instrument and enters into a receive-fixed, pay-variable, interest rate swap to offset the exposure to interest rate risk associated with the debt instrument.

Requirement

Can the entity designate the swap as a cash flow hedge of the future interest cash outflows associated with the debt instrument?

See **Answer** at the end of this chapter.

Interactive question 7: Swap in cash flow hedge 2

An entity manages interest rate risk on a net basis. On 1 January 20X6, it forecasts aggregate cash inflows of £1 million on a fixed rate financial asset and aggregate cash outflows of £900,000 on a fixed rate financial liability in the first quarter of 20X7. For risk management purposes it uses a receive-variable, pay-fixed, forward rate agreement (FRA) to hedge the forecast net cash inflow of
£100,000. The entity designates as the hedged item the first £100,000 of cash inflows on fixed rate assets in the first quarter of 20X7.

Requirement

Can it designate the receive-variable, pay-fixed FRA as a cash flow hedge of the exposure to variability to cash flows in the first quarter of 20X7 associated with the fixed rate assets?

See **Answer** at the end of this chapter.

Worked example: Cash flow hedge – inventories

Bets Co is a manufacturer and retailer of gold jewellery.

On 31 October 20X1, the cost of Bets's inventories of finished jewellery was £8.280 million with a gold content of 24,000 troy ounces. At that date their sales value was £9.938 million.

The selling price of gold jewellery is heavily dependent on the current market price of gold (plus a standard percentage for design and production costs).

Bets's management wished to reduce their business risk of fluctuations in future cash inflow from sale of the jewellery by hedging the value of the gold content of the jewellery. In the past this has proved to be an effective strategy.

Therefore, it sold futures contracts for 24,000 troy ounces of gold at £388 per troy ounce at 31 October 20X1. The contracts mature on 30 October 20X2.

On 30 September 20X2 the fair value of the jewellery was £9.186 million and the forward price of gold per troy ounce for delivery on 30 October 20X2 was £352.

Requirement

Explain how the above transactions would be treated in Bets's financial statements for the year ended 30 September 20X2.

Solution

Bets is hedging the volatility of the future cash inflow from selling the gold jewellery. The futures contracts can be accounted for as a cash flow hedge in respect of those inflows, providing the criteria for hedge accounting are met.

The gain on the forward contract should be calculated as:

	£
Forward value of contract at 31.10.X1 (24,000 × £388)	9,312,000
Forward value of contract at 30.9.X2 (24,000 × £352)	8,448,000
Gain on contract	864,000

The change in the fair value of the expected future cash flows on the hedged item (which is not recognised in the financial statements) should be calculated as:

	£
At 31.10.X1	9,938,000
At 30.9.X2	9,186,000
	752,000

As this change in fair value is less than the gain on the forward contract, the hedge is not fully effective and only £752,000 of the gain on the forward should be recognised in other comprehensive income. The remainder should be recognised in profit or loss:

		£	£
DEBIT	Financial asset (Forward a/c)	864,000	
CREDIT	Other comprehensive income		752,000
CREDIT	Profit or loss		112,000

A hedging relationship continues to qualify for hedge accounting if it is effective. In this case:

- an economic relationship continues to exist between the hedged item and hedging instrument (since they are both gold); and
- the effect of credit risk does not dominate the value changes that result from the economic relationship.

The third criterion for hedge effectiveness is that the hedge ratio of the hedging relationship is the same as that resulting from the quantity of hedged item that the entity actually hedges and the quantity of hedging instrument that the entity actually uses to hedge that quantity of hedged items.

Since this hedge relationship results in a gain on futures contract of £864,000 but a loss on hedged item of only £752,000, it appears that the relationship should be rebalanced.

The current hedge ratio is 1:1 (with hedged item and hedging instrument both based on 24,000 troy ounces of gold); to maintain 100% effectiveness this should be reset by reducing the quantity of hedging instrument to 20,889 troy ounces (752/864 × 24,000) or increasing the quantity of hedged item to 27,574 troy ounces (864/752 × 24,000).

Interactive question 8: Foreign currency hedge 1

Allison Co has a foreign currency liability payable in six months' time and it wishes to hedge the amount payable on settlement against foreign currency fluctuations. To that end, it takes out a forward contract to buy the foreign currency in six months' time. The conditions for hedge accounting were met.

Requirements

8.1 Should the hedge be treated as a fair value hedge of the foreign currency liability or as a cash flow hedge of the amount to be settled in the future?

8.2 How should gains and losses on the liability and the forward contract be accounted for?

See **Answer** at the end of this chapter.

CHAPTER 17

Interactive question 9: Foreign currency hedge 2

An entity exports a product at a price denominated in a foreign currency. At the date of the sale, the entity obtains a receivable for the sale price payable in 90 days and takes out a 90-day forward exchange contract in the same currency as the receivable to hedge its foreign currency exposure.

The conditions for hedge accounting were met.

Under IAS 21, the sale is recorded at the spot rate at the date of sale, and the receivable is restated during the 90-day period for changes in exchange rates with the difference being taken to profit or loss (IAS 21.23 and IAS 21.28).

Requirement

If the foreign exchange forward contract is designated as a hedging instrument, does the entity have a choice whether to designate it as a fair value hedge of the foreign currency exposure of the receivable, or as a cash flow hedge of the collection of the receivable?

How should gains and losses on the receivable and the forward contract be accounted for?

See **Answer** at the end of this chapter.

Interactive question 10: Cash flow hedge

RapidMart is a company that operates a chain of large out of town supermarkets. It has expanded rapidly over the last 10 years, opening new stores in its home country and overseas. It has also moved into a wide range of non-food sales and the provision of services, such as opticians. The company is currently preparing its consolidated financial statements for the year ending 30 September 20X5.

During the last year, RapidMart began to operate an online retail division, RapidMart Direct, as a pilot scheme. The service uses a fleet of delivery vans. This has proved to be very popular with customers and the company wants to expand this operation. The finance director identified a key risk of volatility of diesel prices and has taken out a forward contract to hedge against this.

On 1 August 20X5, RapidMart entered into a forward contract to hedge its expected fuel requirements for the second quarter of the next financial year for delivery of 1 million litres of diesel on 31 December 20X5 at a price of £2.04 per litre.

The company intended to settle the contract net in cash and purchase the actual required quantity of diesel in the open market on 31 December 20X5.

At the company's year end the forward price for delivery on 31 December 20X5 had risen to £2.16 per litre of fuel.

Requirement

How should the above transaction be accounted for in the financial statements of RapidMart for the year ending 30 September 20X5?

See **Answer** at the end of this chapter.

Professional skills focus: Assimilating and using information

The above question contains quite a lot of information, but you should quickly have spotted the fact that RapidMart is expanding and moving into new areas of business. Cash flow is likely to be an issue, as is volatility in prices.

Interactive question 11: Foreign currency receivables and forward contract

Armada is a public limited company reporting under IFRS Standards. It is preparing the financial statements as at 31 December 20X1. Included in trade receivables is an amount due from a customer located abroad. The amount (30.24 million coronna) was initially recognised when the exchange rate was £1 = 5.6 coronna.

At 31 December 20X1, the exchange rate was £1 = 5.4 coronna. No adjustment has been made to the trade receivable since it was initially recognised.

Given the size of the exposure, the company entered into a forward contract, at the same time as the receivable was initially recognised, in order to protect cash flows from fluctuations in the exchange rate. The forward contract is to sell 30.24 million coronna and it satisfies the necessary criteria to be accounted for as a hedge.

In the period between inception of the forward contract and the year end, the loss in fair value of the forward contract was £220,000. The company elected to designate the spot element of the hedge as the hedging relationship. The difference between the change in fair value of the receivable and the change in fair value of the forward contract since inception is the interest element of the forward contract.

Requirement

Show how this transaction should be accounted for in the financial statements of Armada for the year ended 31 December 20X1.

See **Answer** at the end of this chapter.

Interactive question 12: Cash flow hedge

On 1 November 20X2, Blenheim entered into a contract to purchase 3,000 tonnes of refined sunflower oil. The contract is for delivery in February 20X3 at a price of £1,440 per tonne. Blenheim uses sunflower oil to make its products.

At 31 December 20X2, an equivalent new contract for delivery of 3,000 tonnes of refined sunflower oil in February 20X3 could be entered into at £1,400 per tonne.

Blenheim does not intend to take delivery of the sunflower oil and instead intends to settle the contract net in cash, then purchase the actual required quantity based on demand at the time.

The contract is designated as a cash flow hedge of the highly probable forecast purchase of sunflower oil. All necessary documentation was prepared to treat the contract as a cash flow hedge. No accounting entries have been made.

Tax rules follow accounting rules in respect of financial instruments in the tax jurisdiction (with both profit and other comprehensive income items subject to tax at 30%) in which Blenheim operates. No current or deferred tax adjustments have been made for this transaction.

Requirement

Show how this transaction should be accounted for in the financial statements of Blenheim for the year ended 31 December 20X2.

See **Answer** at the end of this chapter.

6.4 Discontinuing cash flow hedge accounting

Cash flow hedge accounting should be discontinued if the hedging instrument expires or is sold, terminated or exercised, if the criteria for hedge accounting are no longer met, a forecast transaction is no longer expected to occur or if the entity revokes the designation.

The discontinuance should be accounted for prospectively ie, the previous accounting entries are not reversed. The cumulative gain or loss on the hedging instrument should be reclassified to profit or loss, as the hedged item is recognised in profit or loss.

7 Hedge of a net investment

Section overview

This section discusses issues specific to the accounting treatment of hedge of net investments.

7.1 Definition

Hedges of a net investment arise in the consolidated accounts where a parent company takes a foreign currency loan in order to buy shares in a foreign subsidiary. The loan and the investment need not be denominated in the same currency, however, assuming that the currencies perform similarly against the parent company's own currency, it should be the case that fluctuations in the exchange rate affect the asset (the net assets of the subsidiary) and the liability (the loan) in opposite ways, hence gains and losses are hedged.

In this type of accounting hedge, the hedging instrument is the foreign currency loan rather than a derivative.

7.2 Accounting treatment

You may understand this type of hedge better after studying consolidation of foreign operations, but in a simple sense, without applying hedging rules:

(a) The loan would be retranslated to the parent's own currency at the year end using the spot exchange rate; any resultant gain or loss would be recognised in profit or loss.

(b) Prior to consolidation, the subsidiary's accounts would be translated into the parent's own currency with any gain or loss recognised in other comprehensive income.

(c) On consolidation, the gain or loss on the loan would affect consolidated profit or loss and the loss or gain on the translation of the subsidiary's net assets would affect consolidated reserves.

The net investment hedge ensures that the gains and losses are both recognised in other comprehensive income and accumulated in reserves by:

- recognising the portion of the gain or loss on the hedging instrument that is determined to be effective in other comprehensive income; and
- recognising the ineffective portion in profit or loss.

Any gain or loss recognised in other comprehensive income is reclassified to profit or loss on the disposal or partial disposal of the foreign operation.

7.3 Hedging with a non-derivative financial instrument

A foreign currency borrowing can be designated as a hedge of a net investment in a foreign operation, with the result that any translation gain or loss on the borrowing should be recognised in other comprehensive income to offset the translation loss or gain on the investment. (For hedges other than hedges of foreign currency risk, when an entity designates a non-derivative financial asset or a non-derivative financial liability measured at fair value through profit or loss as a hedging instrument, it may only designate the non-derivative financial instrument in its entirety or a proportion of it.)

Context example: Use of non-derivative to hedge a net investment

Jenkins Co, whose functional currency is the pound (£), has a subsidiary in France. The subsidiary was purchased on 30 June 20X6 for €20 million and the acquisition was financed with a loan of €20 million. The carrying amount of the subsidiary in the consolidated financial statements (including goodwill acquired in the business combination) is €20 million. Jenkins Co has designated the foreign currency loan of €20 million as a hedge of its net investment in the foreign subsidiary.

Jenkins Co has a 30 June year end. The foreign currency rates at 30 June 20X6 and 30 June 20X7 were £1 = €1.52 and £1 = €1.48 respectively. In the year ended 30 June 20X7, the exchange difference on the **opening** net investment should be calculated as:

	€	£
At 30 June 20X6	20,000,000	13,157,895
At 30 June 20X7	20,000,000	13,513,514
Exchange gain		355,619

There is a corresponding loss on the foreign currency loan of £355,619. Because the hedge is perfectly effective, both the gain and the entire loss will be recognised in other comprehensive income. There is no ineffective portion of the loss on the hedging instrument to be recognised in profit or loss.

7.4 Hedging with derivatives

A net investment can be hedged with a derivative instrument, such as a currency forward contract. In this case, however, it would be necessary to designate at inception that effectiveness can be measured by reference to changes in spot exchange rates or changes in forward exchange rates.

7.5 The effect of re-balancing on hedge accounting

As we saw in section 4, in order to maintain a hedge ratio that complies with hedge effectiveness requirements, a hedge relationship may have to be rebalanced. There are two ways of achieving this.

(a) Increasing or decreasing the volume of the hedging instrument; or

(b) Increasing or decreasing the volume of the hedged item

The effect of a rebalancing on the accounting treatment described in the sections above is as follows:

Volume of hedging instrument increased	No effect on measurement of changes in fair value of original volume of hedging instrument. No effect on measurement of changes in fair value of hedged item. Changes in value of additional volume of hedging instrument are measured starting from the date of rebalancing rather than from the date on which the hedging relationship was designated.

Volume of hedging instrument decreased	No effect on measurement of changes in fair value of volume of hedging instrument that continues to be designated part of the hedge. No effect on measurement of changes in fair value of hedged item. The volume by which the hedging instrument was decreased is no longer part of the hedging relationship. The reporting entity therefore retains a derivative, but only part of it is a hedging instrument in the hedge relationship. The undesignated part of the derivative is accounted for in accordance with normal IFRS 9 requirements ie, at fair value through profit or loss.
Volume of hedged item increased	No effect on measurement of changes in fair value of hedging instrument. No effect on measurement of changes in fair value of original volume of hedged item. Changes in value of additional volume of hedged item are measured starting from the date of rebalancing rather than from the date on which the hedging relationship was designated.
Volume of hedged item decreased	No effect on measurement of changes in fair value of hedging instrument. No effect on measurement of changes in fair value of volume of hedged item that continues to be designated part of the hedge. The volume by which the hedged item was decreased is not part of the hedge from the rebalancing date, and is accounted for as a discontinuation of hedge accounting.

7.6 Summary of hedge accounting

The following table summarises the accounting treatment under IFRS 9 of the main types of hedges.

	Fair value hedge	**Cash flow hedge**
Gain or loss on hedging instrument	Profit or loss (Or OCI if the hedged item is an equity instrument for which an entity has elected to present changes in fair value in OCI)	Other comprehensive income
Adjustment to hedged item	Profit or loss (Or OCI if an equity instrument and OCI election made)	N/A
Hedge ineffectiveness is recorded in profit or loss	Yes	Yes
Gains or losses reclassified to profit or loss later	N/A	Yes

7.7 Types of hedge and their treatment

The following grid will be useful in distinguishing the types of hedge and their treatment.

	Firm commitment	**Forecast transaction (highly probable)**
Foreign currency	Either fair value hedge or cash flow hedge	Cash flow hedge
Other	Fair value hedge	Cash flow hedge

Professional skills focus: Structuring problems and solutions

It may not be immediately obvious what type of hedge is being used. The above tables sum up the treatment and can be used as an overview in order to structure your thinking about the information in the question.

Interactive question 13: Comprehensive fair value hedge

Toprate Exports, whose functional currency is the dollar (USD), has significant receipts in pounds sterling (GBP). In order to protect itself from currency fluctuations relating to its foreign currency receivables, it frequently enters into contracts to sell GBP forward. On 31 October 20X1 the company recognised a receivable of GBP 1 million, due on 31 January 20X2.

On 31 October 20X1 the company entered into a three-month forward contract for settlement on 31 January 20X2 to sell GBP 1 million at USD 1 = GBP 0.6202. The spot rate on 31 October 20X1 was USD 1 = GBP 0.6195.

At 31 December 20X1, the forward rate for settlement on 31 January 20X2 was USD 1 = GBP 0.6440 (spot rate on 31 December 20X1 was USD 1 = GBP 0.6435).

The applicable dollar yield curve gives the following (annualised) rate for discounting a cash flow occurring on 31 January 20X2:

At 31 December 20X1 0.325%

The company set up the appropriate documentation on 31 October 20X1 to treat the forward contract as a fair value hedge and designated the hedging relationship as being changes in the spot element of the forward exchange contract.

Requirement

Explain, showing relevant financial statement extracts, the accounting treatment of these transactions in Toprate Exports's financial statements (insofar as the information provided permits) for the year ended 31 December 20X1. (Notes to the financial statements are not required.)

You should perform any discounting necessary to the nearest month and work to the nearest $1.

See **Answer** at the end of this chapter.

8 Disclosures

Section overview

This section covers the disclosures required in respect of hedging.

Under IFRS 7, *Financial Instruments: Disclosures* an entity should disclose the following separately for each type of hedge described in IFRS 9 (ie, fair value hedges, cash flow hedges and hedges of net investments in foreign operations):

- A **description** of each type of hedge
- A **description** of the financial instruments designated as hedging instruments and their fair values at the reporting date
- The **nature of the risks** being hedged

For **cash flow hedges**, an entity should disclose the following:

- The periods when the cash flows are expected to occur and when they are expected to affect profit or loss
- A description of any forecast transaction for which hedge accounting had previously been used, but which is no longer expected to occur
- The amount that was recognised in other comprehensive income during the period
- The amount that was reclassified from equity to profit or loss for the year, showing the amount included in each line item in the statement of comprehensive income
- The amount that was reclassified from equity during the period and included in the initial cost or other carrying amount of a non-financial asset or non-financial liability whose acquisition or incurrence was a hedged highly probable forecast transaction

An entity should **disclose the following separately**:

- In fair value hedges, gains or losses:
  - on the hedging instrument; and
  - on the hedged item attributable to the hedged risk
- The ineffectiveness recognised in profit or loss that arises from cash flow hedges
- The ineffectiveness recognised in profit or loss that arises from hedges of net investments in foreign operations

9 IAS 39 requirements on hedge accounting

Section overview

- This section provides an overview of the hedging rules in IFRS 9's predecessor, IAS 39, *Financial Instruments: Recognition and Measurement*.
- Entities may apply the new IFRS 9 rules in their entirety, or entities may apply the hedge accounting rules of IAS 39 to all of their hedging relationships while following the classification and measurement rules of IFRS 9.
- Entities undertaking macro hedging activities may apply the new general hedge accounting model in IFRS 9 while continuing to apply the specific macro hedging requirements of IAS 39.
- IFRS 9 is the default standard for your exam.

Note: For the purpose of the exam, the candidate would be expected to use IFRS 9, but must understand the main differences in IAS 39, which can still be applied with regard to hedging.

9.1 What is macro hedging?

Macro hedging, also known as portfolio hedging, is a technique whereby financial instruments with similar risks are grouped together and the risks of the portfolio are hedged together.

Often this is done on a net basis with assets and liabilities included in the same portfolio. For example, instead of using interest rate swaps to hedge interest rate exposure on a loan by loan basis, banks hedge the risk of their entire loan book or specific portions of the loan book.

Currently, IFRS 9 does not address macro hedging.

In general, IAS 39 does not permit an overall net position to be designated as a hedged item, for example a UK entity that has to make a purchase of £10 million in 30 days and a sale of £2 million in 30 days cannot designate the net purchase of £8 million as the hedged item. The exception is that IAS 39 permits macro hedging for the interest rate risk associated with a portfolio of financial assets or liabilities. There are, however, clearly prescribed procedures that must be followed in order to do so.

9.2 IAS 39 hedging differences

A number of aspects of hedge accounting are different under IAS 39; however, the **following are the same as IFRS 9**:

- The terminology used in IAS 39 and IFRS 9 is generally the same.
- The three types of hedges – fair value hedge, cash flow hedge and net investment hedge are the same.
- Hedge ineffectiveness is recognised in profit or loss except for the other comprehensive income option for equity investments.
- Hedge accounting with written options is prohibited.

9.3 IFRS 9 hedging vs IAS 39 hedging: summary of key differences

The IFRS 9 model for hedge accounting differs from that in IAS 39 in the following key areas:

	IFRS 9	IAS 39
Eligibility of hedging instruments	Any financial instrument may be a hedging instrument if it is measured at fair value through profit or loss.	Derivatives may be designated as hedging instruments. Non-derivatives may be designated as hedging instruments only for hedge of foreign currency risk.
Therefore, under IAS 39 non-derivative items are less widely used as hedging instruments than under IFRS 9.		
Eligibility of hedged items	In addition to IAS 39 eligible hedged items, IFRS 9 allows a risk component of a non-financial asset or liability to be designated as a hedged item in some circumstances.	Recognised assets, liabilities, firm commitments, highly probable forecast transactions and net investments in foreign operations may be designated as hedged items. In some circumstances, risk components of a financial asset or liability may be designated as a hedged item.
Therefore fewer items can be designated as hedged items under IAS 39.		
Qualifying criteria for applying hedge accounting	Hedge effectiveness criteria are principles-based and aligned with risk management activities.	A hedging relationship only qualifies for hedge accounting if certain criteria are met, including a quantitative hedge effectiveness test under which hedge effectiveness must fall in the range 80% – 125%.

	IFRS 9	IAS 39
Therefore genuine hedging relationships captured by IFRS 9 may be missed when applying IAS 39 rules.		
Rebalancing	Rebalancing is permitted by IFRS 9 in some circumstances (see above).	The concept of rebalancing does not exist within IAS 39.
Lack of guidance on rebalancing means that hedge accounting needs to be discontinued under IAS 39, while it could continue under IFRS 9.		
Discontinuation of hedging relationships	Hedge accounting may not be discontinued where the hedging relationship continues to meet qualifying criteria. Can only discontinue when qualifying criteria are no longer met.	Hedge accounting may be discontinued at any time.
The absence of strict discontinuation rules means that IAS 39 was less precise than IFRS 9.		
Accounting for the time value component of options and forward contracts	The time value component of an option is a cost of hedging presented in OCI.	The forward element of a forward contract may also be presented in OCI. The part of an option that reflects time value and the forward element of a forward contract are treated as derivatives held for trading purposes.
IAS 39 therefore led to greater volatility in profit or loss than IFRS 9 does.		

10 Audit focus: fair value

Section overview

- Fair value measurements of assets, liabilities and components of equity may arise from both the initial recording of transactions and later changes in value.
- Auditing fair value requires both the assessment of risk and evaluating the appropriateness of the fair value and how it is disclosed.
- Fair value is a key issue to investment property, pension costs, share-based payments and many other areas of financial accounting.

10.1 Audit issues around fair value

For the auditor, the use of fair values will raise a number of issues. The determination of fair value will generally be **more difficult** than determining historical cost. It will be more difficult to establish whether fair value is reasonable for complex assets and liabilities than for more straightforward assets or liabilities which have an actively traded market and therefore a market value.

Generally speaking, the trend towards fair value accounting will increase audit work required, not only because determining fair values is more difficult, but also because **fair values fluctuate** in a way that historical costs do not, and will need vouching each audit period. Fair value will, for the same reasons, **increase audit risk**.

ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures* addresses the ongoing **complexity** and **subjectivity** of accounting estimates in company accounts (including those related to financial instruments) by considering factors such as **estimation uncertainty** for management and **professional scepticism** for auditors when assessing such estimates. ISA 540 (revised) is covered in more detail in earlier chapter.

10.2 Auditing fair values

ISA 540 (Revised) considers all accounting estimates, including those that relate to fair value. In overview, the standard requires the following when auditing fair values.

- When assessing the risk of material misstatement, ISA 540 (Revised) requires auditors to consider both the **entity and its environment** and any **internal controls** in place at the entity (ISA 540.13).
- **Risk assessment** is usually split into **inherent** and **control risks** (ISA 540.16):
  - **Inherent risks** would include the inherent complexity and subjectivity associated with fair values, such as changes in the marketplace (ISA 540.A59).
  - **Control risk** would consider the techniques used by management in creating accounting estimates, especially if models are required (ISA 540.A39) or the use of an expert for calculations requiring complicated level 3 fair values (ISA 540.A31).
- The audit of fair value estimates is a contest between auditor and management, where **professional scepticism** is used by the former to counter the risk of **bias** by the latter (ISA 540.32).
  - For example, when reviewing ranges subject to estimation uncertainty, auditors should consider the reasonableness of ranges used by management to reach such amounts (ISA 540.A47).
  - Auditors should also consider if suitable **segregation of duties** exists in departments who are responsible for deriving fair value estimates for which they would receive a bonus (ISA 540.A51).
- **Subsequent events** are used to assess the reasonableness of fair value estimates (ISA 540. A92).
- The auditor should adopt suitable procedures for determining adequate **disclosure** (ISA 540.31) especially in relation to the various **quantitative** and **qualitative** risks involved.

11 Auditing financial instruments

Section overview

- Financial instruments include items such as cash, accounts receivable and payable, loans receivable and payable, debt and equity investments, and derivatives.
- Financial instruments should be classified as either financial assets, financial liabilities or equity instruments.
- The key audit issue with these instruments is risk and IAS 32; IFRS 9 and IFRS 7 deal with the accounting/disclosure related to these instruments.
- Guidance for the auditor is provided by IAPN 1000.

11.1 IAPN 1000

IAPN 1000, *Special Considerations in Auditing Financial Instruments* was developed to help auditors with different levels of familiarity with financial instruments. It is therefore structured in two sections. Section I provides background and educational material to help those less familiar with financial instruments to understand some of the common features, and how they are used, managed and controlled by entities and particular financial reporting issues. Section II provides guidance on the relevant auditing considerations.

The introduction of the IAPN sets out the scope. It explains that the IAPN does not address the simplest financial instruments such as cash, simple loans, trade accounts receivable and trade accounts payable, nor the most complex ones. It also does not address specific accounting requirements, such as those relating to hedge accounting, offsetting or impairment.

11.1.1 Section I – Background information about financial instruments Purpose and risks of using financial instruments

Financial instruments are used for the following purposes:

- Hedging purposes (ie, to change an existing risk profile to which an entity is exposed)
- Trading purposes (ie, to enable an entity to take a risk position to benefit from long-term investment returns or from short-term market movements)
- Investment purposes (eg, to enable an entity to benefit from long-term investment returns)

Management and those charged with governance might not:

- fully understand the risks of using financial instruments
- have the expertise to value them appropriately
- have sufficient controls in place over financial instrument activities

Business risk and the risk of material misstatement also increase when management inappropriately hedge risk or speculate.

In particular the entity may be exposed to the following types of risk:

(a) Credit risk (the risk that one party will cause a financial loss to another party by failing to discharge an obligation)

(b) Market risk (the risk that the fair value or future cash flow of a financial instrument will fluctuate because of changes in market prices eg, currency risk, interest rate risk, commodity and equity price risk)

(c) Liquidity risk (includes the risk of not being able to buy or sell a financial instrument at an appropriate price in a timely manner due to a lack of marketability for that financial instrument)

(d) Operational risk (related to the specific processing required for financial instruments)

The risk of fraud may also be increased where an employee in a position to perpetrate a financial fraud understands both the financial instruments and the process for accounting for them, but management and those charged with governance have a lesser degree of understanding.

Professional skills focus: Applying judgement

Fair value is an area where judgement must be applied, particularly in the context of financial instruments where some instruments, such as derivatives and options, are high risk.

Controls relating to financial instruments

The level of sophistication of an entity's internal control will be affected by the size of the entity and the extent and complexity of the financial instruments used. An entity's internal control over financial instruments is more likely to be effective when management and those charged with governance have:

(a) established an appropriate control environment;

(b) established a risk management process;

(c) established information systems that provide an understanding of the nature of the financial instrument activities and the associated risks; and

(d) designed, implemented and documented a system of internal control to:

    (1) provide reasonable assurance that the use of financial instruments is within the entity's risk management policies;

    (2) properly present financial instruments in the financial statements;

    (3) ensure that the entity is in compliance with applicable laws and regulations; and

    (4) monitor risk.

The Appendix to IAPN 1000 provides examples of controls that may exist in an entity that deals with a high volume of financial instrument transactions. These include authorisation, segregation of duties (particularly of those executing the transaction (dealing) and those initiating cash payments and receipts (settlements)) and reconciliations of the entity's records to external banks' and custodians' records.

Completeness, accuracy and existence

The IAPN discusses a number of practical issues. For example, it explains that where transactions are cleared through a clearing house the entity should have processes to manage the information delivered to the clearing house. Adequate IT controls must also be maintained.

It also explains that in financial institutions where there is a high volume of trading, a senior employee typically reviews daily profits and losses on individual traders' books to evaluate whether they are reasonable based on the employee's knowledge of the market. Doing so may enable management to determine that particular trades were not completely or accurately recorded, or may identify fraud by a particular trader.

Valuation of financial instruments

Section I also provides material on financial reporting requirements. It explains that many financial reporting frameworks require financial instruments, including embedded derivatives, to be measured at fair value. In general, the objective of fair value is to arrive at the price at which an orderly transaction would take place between market participants at the measurement date under current market conditions; that is, it is not the transaction price for a forced liquidation or distressed sale. In meeting this objective all relevant market information is taken into account. It also explains that fair value measurement may arise at both the initial recording of transactions and later when there are changes in value. Changes in fair value measurement may be treated differently depending on the reporting framework. The IAPN then explores features of different financial reporting frameworks, including the following:

- The fair value hierarchy (as adopted by IFRS 13)
- The effects of inactive markets
- Management's valuation processes
- The use of models, third-party pricing sources and experts (entities often make use of a third party to obtain fair value information, particularly when expertise or data are required that management does not possess)

11.1.2 Section II – Audit considerations relating to financial instruments

IAPN 1000 identifies certain factors that make auditing complex financial instruments particularly challenging:

- Management and the auditors may find it difficult to understand the nature of the instruments and the risks to which the entity is exposed.
- Markets can change quickly, placing pressure on management to manage their exposures effectively.
- Evidence supporting valuation may be difficult to obtain.
- Individual payments may be significant, which may increase the risk of misappropriation of assets.
- The amount recorded may not be significant, but there may be significant risks and exposures associated with these complex financial instruments.
- A few employees may exert significant influence on the entity's financial instruments transactions, in particular where compensation arrangements are tied to revenue from these.

Professional scepticism

The need for professional scepticism increases with the complexity of the financial instruments, for example with regard to the following:

- Evaluating whether sufficient appropriate audit evidence has been obtained (which can be particularly challenging when models are used or in determining if markets are inactive)
- Evaluating management's judgements and potential for management bias in applying the applicable financial reporting framework (eg, choice of valuation techniques, use of assumptions in valuation techniques)
- Drawing conclusions based on the audit evidence obtained (for example assessing the reasonableness of valuations prepared by management's experts)

Planning considerations

The auditor's focus in planning is particularly on the following:

- Understanding the accounting and disclosure requirements

  ISA 540 requires the auditor to obtain an understanding of the requirements of the applicable financial reporting framework relevant to accounting estimates.
- Understanding the complex financial instruments This helps the auditor to identify

  whether:
  - important aspects of a transaction are missing or inaccurately recorded;
  - a valuation appears appropriate;
  - the risks inherent in them are fully understood and managed by the entity; or
  - the financial instruments are appropriately classified into current and non-current assets and liabilities.

  Understanding management's process for identifying and accounting for embedded derivatives will help the auditor to understand the risks to which the entity is exposed.
- Determining whether specialised skills and knowledge are needed in the audit.

  The engagement partner must be satisfied that the engagement team and any auditor's experts collectively have the appropriate competence and capabilities.
- Understanding and evaluating the system of internal control in the light of the entity's financial instrument transactions and the information systems that fall within the scope of the audit.

  This understanding must be obtained in accordance with ISA 315. This understanding enables the auditor to identify and assess the risks of material misstatement at the financial statement and assertions levels, providing a basis for designing and implementing responses to the assessed risks of material misstatement.

- Understanding the nature, role and activities of the internal audit function

  Areas where the work of the internal audit function may be particularly relevant are as follows:

  - Developing a general overview of the extent of use of financial instruments
  - Evaluating the appropriateness of policies and procedures and management's compliance with them
  - Evaluating the operating effectiveness of financial instrument control activities
  - Evaluating systems relevant to financial instrument activities
  - Assessing whether new risks relating to financial instruments are identified, assessed and managed

- Understanding management's process for valuing financial instruments, including whether management has used an expert or a service organization.

  Again this understanding is required in accordance with ISA 540.

- Assessing and responding to the risk of material misstatement (see below)

Assessing and responding to the risk of material misstatement

Factors affecting the risk of material misstatement include the following:

- The volume of financial instruments to which the entity is exposed
- The terms of the financial instruments
- The nature of the financial instruments
- Fraud risk factors (eg, where there are employee compensation schemes, difficult financial market conditions, ability to override controls)

The assessment of risk will determine the appropriate audit approach in accordance with ISA 330, *The Auditor's Responses to Assessed Risks*, including substantive procedures and tests of controls. Where the entity is involved in a high level of trading and use of financial instruments, it is unlikely that sufficient evidence will be obtained through substantive testing alone. Where there are relatively few transactions of this nature a substantive approach may be more efficient. In reaching a decision on the nature, timing and extent of testing of controls the auditor may consider factors such as:

- the nature, frequency and volume of financial instrument transactions;
- the strength of controls including design;
- the importance of controls to the overall control objectives;
- the monitoring of controls and identified deficiencies in control procedures;
- the issues controls are intended to address;
- frequency of performance of control activities;
- level of precision the controls are intended to achieve;
- evidence of performance of control activities; and
- timing of key financial instrument transactions (eg, whether they are close to the period end).

Designing substantive procedures will include consideration of the following:

- Use of analytical procedures – they may be less effective as substantive procedures when performed alone, as the complex drivers of valuation often mask unusual trends

- Non-routine transactions – this applies to many financial instrument transactions and a substantive approach will normally be the most effective means of achieving the planned audit objectives
- Availability of evidence – eg, when the entity uses a third-party pricing source, evidence may not be available from the entity
- Procedures performed in other audit areas – these may provide evidence about completeness of financial instrument transactions eg, tests of subsequent cash receipts and payments, and the search for unrecorded liabilities
- Selection of items for testing – where the financial instrument portfolio comprises instruments with varying complexity and risk judgemental sampling may be useful

In some cases 'dual-purpose' tests may be used ie, it may be efficient to perform a test of controls and a test of details on the same transaction eg, testing whether a signed contract has been maintained (test of controls) and whether the details of the financial instrument have been appropriately captured in a summary sheet (test of details). Areas of significant judgement would normally be tested close to, or at, the period end.

Procedures relating to completeness, accuracy, existence, occurrence and rights and obligations may include the following:

- Remaining alert during the audit when inspecting records or documents (eg, minutes of meetings of those charged with governance, specific invoices and correspondence with the entity's professional advisers)
- External confirmation of bank accounts, trades and custodian statements
- Reconciliation of external data with the entity's own records
- Reading individual contracts and reviewing support documentation
- Reviewing journal entries or the internal control over the recording of such entries to determine if entries have been made by employees other than those authorised to do so
- Testing controls eg, by reperforming controls

Valuation of financial instruments

Management is responsible for the valuation of complex financial instruments and must develop a valuation methodology. In testing how management values the financial instrument, the auditor should undertake one or more of the following procedures:

(a) Test how management made the accounting estimate and the data on which it is based (including any models)

(b) Test the operating effectiveness of controls over how management made the accounting estimate, together with appropriate substantive procedures

(c) Develop a point estimate or a range to evaluate management's point estimate

(d) Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate

Audit procedures may include the following:

- Reviewing and assessing the judgements made by management
- Considering whether there are any other relevant price indicators or factors to take into account
- Obtaining third-party evidence of price indicators eg, by obtaining a broker quote
- Assessing the mathematical accuracy of the methodology employed
- Testing data to source materials

Significant risk

The auditor's risk assessment may lead to the identification of one or more significant risks relating to valuation. The following circumstances would be indicators that a significant risk may exist:

- High measurement uncertainty
- Lack of sufficient evidence to support management's valuation
- Lack of management understanding of its financial instruments or expertise to value these correctly
- Lack of management understanding of the complex requirements of the applicable financial reporting framework
- The significance of valuation adjustments made to model outputs when the applicable reporting framework requires or permits such adjustments

Where significant risks have been identified the auditor is required to evaluate how management has considered alternative assumptions or outcomes and why it has rejected them, or how management has addressed estimation uncertainty in making the accounting estimate. The auditor must also evaluate whether the significant assumptions used by management are reasonable. To do this the auditor must exercise professional judgement.

The IAPN also considers audit considerations for valuation in three specific circumstances: when management uses a third-party pricing source, when management estimates fair value using a model and when a management's expert is used.

Possible approaches to gathering evidence regarding information from third-party pricing sources may include the following:

- For Level 1 inputs, comparing the information from third-party pricing sources with observable market prices
- Reviewing disclosures provided by third-party pricing sources about their controls and processes, valuation techniques, inputs and assumptions
- Testing the controls management has in place to assess the reliability of information from third- party pricing sources
- Performing procedures at the third-party pricing source to understand and test the controls and processes, valuation techniques, inputs and assumptions used for asset classes or specific financial instruments of interest
- Evaluating whether the prices obtained from third-party pricing sources are reasonable in relation to prices from other third-party pricing sources, the entity's estimate or the auditor's own estimate
- Evaluating the reasonableness of valuation techniques, assumptions and inputs
- Developing a point estimate or a range for some financial instruments priced by the third-party pricing source and evaluating whether the results are within a reasonable range of each other
- Obtaining a service auditor's report that covers the controls over validation of the prices

When management estimates fair value using a model IAPN 1000 states that testing the model can be accomplished by two main approaches:

(a) The auditor can test management's model, by considering the appropriateness of the model used by management, the reasonableness of the assumptions and data used, and the mathematical accuracy.

(b) The auditor can develop their own estimate and then compare the auditor's valuation with that of the entity.

When a management expert is used the requirements which must be applied are the basic requirements of ISA 500 as discussed in earlier chapter. Procedures would include evaluating the competence, capabilities and objectivity of the management's expert, obtaining an understanding of their work and evaluating the appropriateness of that expert's work as audit evidence.

Presentation and disclosure

Audit procedures around presentation and disclosure are designed in consideration of the assertions of occurrence and rights and obligations, completeness, classification and understandability, and accuracy and valuation.

Professional skills focus: Concluding, recommending and communicating

As was mentioned in connection with derivatives in the previous chapter, the complexity of hedging makes clear and transparent communication essential.

Other relevant audit considerations

Written representations should be sought from management in accordance with ISA 540 (revised) and ISA 580, *Written Representations*.

11.1.3 Practice Note 23

Practice Note 23 *Special Considerations in Auditing Financial Instruments* was revised in July 2013. The revised Practice note is based on IAPN 1000 discussed above. Some additional points are however included as follows:

Section 1

- Operational risk includes model risk (the risk that imperfections and subjectivity of valuation models are not properly understood, accounted for or adjusted for) (PN23.18)
- Complete and accurate recording of financial instruments is an essential core objective (PN23.24- 1)
- When quoted prices are used as evidence of fair value, the source should be independent and where possible more than one quote (PN23.44-1)
- Where a price has been obtained from a pricing service and that price has been challenged, when considering whether the corrected price is a suitable basis for valuation, consideration should be given to how long the challenge process has taken and whether the underlying data remains valid (PN23.56-1)
- A key control over management's valuation process may be an independent price verification function which forms part of internal control (PN23.62-1)

Section 2

- Although it is not part of the auditor's role to determine the amount of risk an entity should take on, obtaining an understanding of the risk management process may identify risks of material misstatement (PN23.70-1)
- Assertions about valuation may be based on highly subjective assumptions, therefore evaluating audit evidence in respect of these requires considerable judgment (PN23.71-2)
- Determining materiality for financial instruments may be particularly difficult (PN23.73-1)
- When deciding which audits other than those of listed entities require an engagement quality control review, the existence of financial instruments may be a relevant factor (PN23.73-2)

- When obtaining an understanding of the entity's financial instruments, the auditor will consider the view of any correspondence with regulators in accordance with the FCA Code (PN23.76-2)
- The involvement of experts or specialists may be needed (PN23.79)
- The auditor may need to consider the control environment applicable to those responsible for functions dealing with financial instruments (PN23.89-2)
- Substantive procedures will include reviewing operational data such as reconciling differences (PN23.104)
- The auditor may use information included in a Prudent Valuation Return (prepared by UK banks and other regulated entities in the financial sector) to understand the uncertainties associated with the financial instruments used and disclosed by these entities (PN23.108-1)
- Tests of valuation include: verifying the external prices used to value financial instruments, confirming the validity of valuation models, and evaluating the overall results and reserving for residual uncertainties (PN23.113-1)
- The auditor must consider whether management has given proper consideration to the models used (PN23.134-1)
- When evaluating the amount of an adjustment that might be required, the auditor considers all factors taken into account in the valuation process and uses experience and judgment (PN23.137- 1)

Interactive question 14: Convertible debenture

On 1 January 20X8 Berriman plc issued a £10 million debenture at par. The debenture has a nominal rate of interest of 4% and is redeemable on 1 January 20Y3. On this date, the holder has the option to convert the debenture to 6 million £1 ordinary shares in Berriman plc. The financial statements currently show a long-term liability which represents the net proceeds of the debenture. The first payment of interest on 31 December 20X8 has also been recorded.

Requirements

14.1 Identify the issues surrounding this debenture.

14.2 List the audit procedures you would perform.

14.3 See **Answer** at the end of this chapter.

Context example: Royal Bank of Scotland

In the Royal Bank of Scotland (RBS)'s financial statements for the year ended 31 December 2014, Deloitte, RBS's statutory auditors, noted that the valuation of complex or illiquid financial instruments was an area of audit risk which had merited specific audit focus. Their auditor's report described the risk, and the audit team's responses to the risk, as follows:

Risk

The valuation of the Group's financial instruments was a key area of focus of our audit given the degree of complexity involved in valuing some of the financial instruments and the significance of the judgements and estimates made by the directors. As set out in Note 11 of the consolidated financial statements, financial instruments held at fair value comprised assets of £534 billion and liabilities of £497 billion. In the Group's accounting policies, the directors have described the key sources of estimation involved in determining the valuation of financial instruments and in particular when the fair value is established using a valuation technique due to the instrument's complexity or due to the lack of availability of market-based data.

Our audit has focused on testing the valuation adjustments including those for credit risk, funding related and own credit. A particular area of focus of our audit has been in testing the valuation of the more illiquid financial instruments disclosed as Level 3 instruments which comprised assets of £5 billion and liabilities of £5 billion.

How the scope of our audit responded to the risk

We tested the design and operating effectiveness of the key controls in the Group's financial instrument valuation processes including the controls over data feeds and other inputs into valuation models and the controls over testing and approval of new models or changes to existing models.

Our audit work also included testing a sample of the underlying valuation models and the assumptions used in those models using a variety of techniques. This work included valuing a sample of financial instruments using independent models and source data and comparing the results to the Group's valuations and the investigation of any significant differences.

For instruments with significant, unobservable valuation inputs, we used our own internal valuation experts to assess and challenge the valuation assumptions used, including considering alternative valuation methodologies used by other market participants.

12 Auditing derivatives

Section overview

It is necessary for auditors to understand the process of derivative trading in order to audit derivatives successfully.

12.1 Auditing derivatives in the modern world

The key to using derivatives as part of an overall investment strategy is to have **adequate internal controls** in place and trained personnel handling the investments. Derivatives, which have been around for a very long time in one form or another, have been put to good use by transferring risk from one party, the hedger, to another, the speculator. There are many factors in today's world which can cause derivative investment strategies to go wrong. As we have seen, such factors can include the following:

- A lack of internal controls
- A *laissez-faire* management
- Greed
- Ineffective systems to identify and monitor risk
- Inexperience

An understanding of the business process involved in derivatives trading is necessary in order to audit derivatives successfully. The steps in a typical process are as follows:

(a) Entering the deal in the trader's deal sheet

(b) Trader types the deal into the system and sends an email

(c) The back office include the deal in reports

(d) Back office process the deal using market quote information from agencies

(e) Enter details into a 'pre-programmed' Excel sheet and/or other processing package

(f) Confirm deal with brokers/counterparties

(g) Carry out monthly settlement/processing

(h) Net off between Accounts Payable and Accounts Receivable and wire the payment as necessary

Each type of derivative will be different and non-standard derivatives will be **unique**. This poses challenges for the auditor.

Generally, however, the auditor should seek to:

(a) **understand the client's business** in order to establish the real role played by, and the risks that are inherent in, the derivatives activity;

(b) **document the system**. This would involve documenting various processes;

(c) **identify the controls** in each process in order to establish the risk passed to the client by inadequate or missing controls; and, therefore, to establish the audit risk and thus the audit work that needs to be performed;

(d) carry out the **appropriate control and substantive audit procedures**; and

(e) make **conclusions and report** on the outcome of the audit of derivatives.

Obviously the exact nature of what is to be done is dependent on the circumstances of the client. Ensuring that the information has been captured **completely and accurately** in each case is important.

Worked example: Systems and processes

Typically a large oil refining company in one country will obtain oil from different sources and refine it, producing various petroleum products for its customers.

Imagine the company is involved in trading in crude oil futures. The traders will take forward positions strategically with the information relating to future oil price movement available at the time. If the traders expect the price to rise, they will take a long position (buy the commodity forward) and if they expect it to fall they will take a short position (sell the commodity forward).

Requirement

Identify the key processes that the auditor would seek evidence for in connection with this.

Solution

Capture of information: The primary source document is the trader's deal sheet. This document should contain the date, time, oil index, quantity traded, position (long or short), nature of trade (hedge or speculation) and rationale for the trade.

Processing of information: The back office report should contain the same information as in the deal sheet.

Confirmation of information: There should be a statement from the clearing agents (since these are futures) confirming the details. (**Note:** Swaps transactions would be confirmed differently, via counterparty and broker confirmations and options are confirmed in the same way that futures are.)

Depositing of margin money: There should be evidence that margin money had been deposited with the exchange as required (in case the mark to market crosses the exchange's threshold limits).

Settlement: There will be clearing statements from clearing agents. These should be used in collaboration with internally generated information to confirm that the appropriate settlement amounts changed hands.

Accounting: The deals have been accounted for correctly.

In all these processes controls will have been implemented and the auditor should identify these and assess their utility.

Interactive question 15: Derivatives

You are the auditor in charge of the audit of Johannes plc, a UK company with the pound (£) as its functional currency.

On 1 January 20X7, Johannes plc (J) entered into a forward contract to purchase 40,000 barrels of crude oil at $70 per barrel on 1 January 20X9. J is not using this as a hedging instrument and is speculating that the price of oil will rise and plans to net settle the contract if the price rises. J does not pay anything to enter into this forward contract. At 31 December 20X7, the fair value of the forward contract has increased to £500,000. At 31 December 20X8, the fair value of the forward contract has declined to £400,000.

Requirements

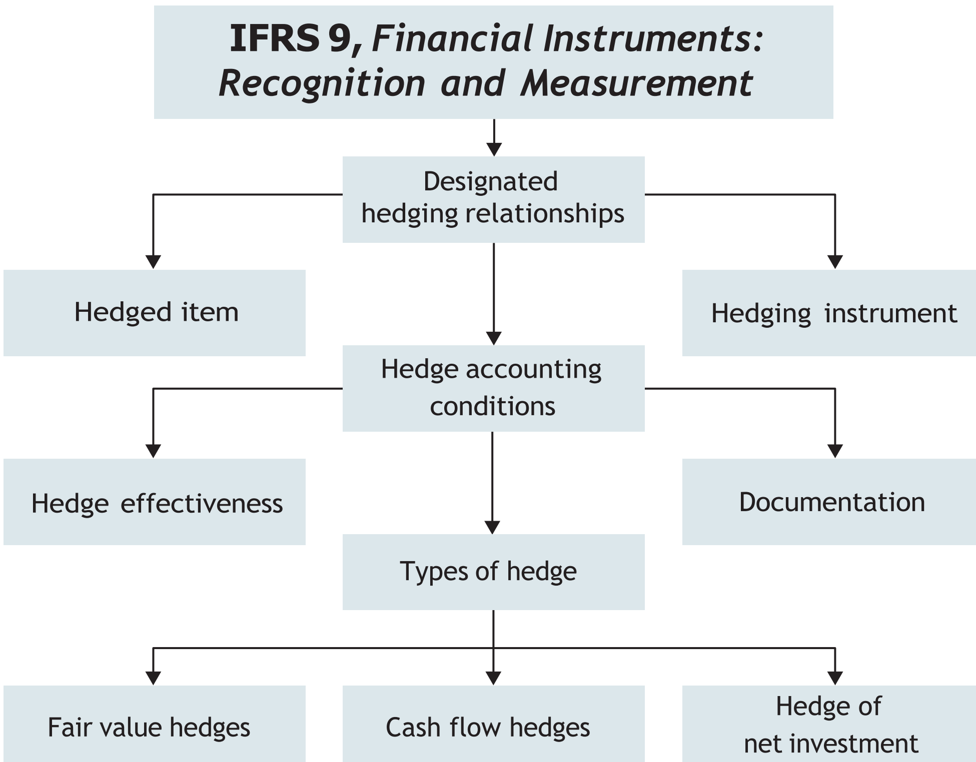
15.1 Identify the accounting entries you would expect to see at the inception of the contract, at 31 December 20X7, and at 31 December 20X8.

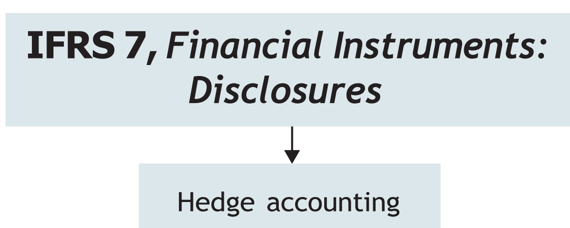
15.2 Identify the risks you would expect to find in this arrangement, and the audit procedures that you would carry out.

15.3 Outline the steps that you would take to ensure compliance with IFRS 7, *Financial Instruments: Disclosures*.

See **Answer** at the end of this chapter.

Summary


IFRS 9, *Financial Instruments: Recognition and Measurement*
Designated hedging relationships
Hedged item
Hedging instrument
Hedge accounting conditions
Hedge effectiveness
Documentation
Types of hedge
Fair value hedges
Cash flow hedges
Hedge of net investment


IFRS 7, *Financial Instruments: Disclosures*
Hedge accounting

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	What are the three types of hedge dealt with in IFRS 9, *Financial Instruments*? (Topic 1)
2.	What is a hedged item? (Topic 2)
3.	Which contracts can be designated as hedging instruments? (Topic 3)
4.	Do you understand the conditions that must be met for hedge accounting to be applied? (Topic 4)
5.	How should a hedge of a firm commitment be treated? (Topic 6)
6.	What are the main issues for the auditor when auditing derivatives? (Topic 7)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Hedging	This is a short, straightforward introduction to a complex topic.
JayGee	This question requires explanation rather than calculation, which could happen in an exam, particularly in the context of decision making for the future.
Anew	This is an integrated question, which revises derivatives, covered in an earlier chapter and tests the audit, trading and hedging aspects.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios to help you improve knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Kime (note 2 only)	This part of the question deals with hedging a trade receivable from a customer located abroad using a forward contract.
Johnson Telecom	This is a must-do full question on financial instruments, integrating FR and audit. Instruments covered are: investments in equity instruments, derivatives (with hedging), debt investments and a loan note.

Tydaway (forward contract with China only)	You are asked to consider four hedging scenarios relating to how the forward contract should be treated.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries.

Once you have attempted these questions, you can continue your studies by moving onto the next chapter.

Technical reference

1 Hedging relationships – IFRS 9

- Types of hedging relationships – **IFRS 9.6.1**
- Examples – **IFRS 9. IE**

2 Hedge accounting

- Definition – **IFRS 9 Appendix A**
- Conditions – **IFRS 9 6.4.1**

3 Hedging instruments

- Qualifying instruments – **IFRS 9 6.2.1**
- Written and purchased options – **IFRS 9 6.2.1**
- Non-qualifying instruments – **IFRS 9 6.4.1**
- Designations of hedging instruments – **IFRS 9 6.2.1**

4 Fair value hedges

- Definition – **IFRS 9 Appendix A**
- Recognition of gains or losses – **IFRS 9 6.5.1**
- Discontinuing fair value hedge accounting – **IFRS 9 6.5.1**

5 Cash flow hedges

- Definition – **IFRS 9 Appendix A**
- Recognition of gains or losses – **IFRS 9 6.5.1**
- Hedge of a forecast transaction – **IFRS 9 6.5.1**
- Discontinuing cash flow hedge accounting – **IFRS 9 6.5.1**

6 Hedges of a net investment – IFRS 9 6.5.1

7 Hedge effectiveness

- Criteria – **IFRS 9 6.4.1**
- Timing of assessment and methods of assessing effectiveness – **IFRS 9 6.4.1**

8 Auditing fair value measurements and disclosures

- Understanding the entity's process – **ISA 540.8**
- Evaluating reasonableness – **ISA 540.18, A116–A119**
- Audit procedures – **ISA 540.13**
- Written representations – **ISA 540.22**

9 Auditing financial instruments

- Professional scepticism – **IAPN 1000.71**
- Planning – **IAPN 1000.73–.84**
- Substantive procedures – **IAPN 1000.96**
- Valuation – **IAPN 1000.114, .118**

Self-test questions

Answer the following questions

1 Hedging

A company owns 100,000 barrels of crude oil which were purchased on 1 July 20X2 at a cost of $26.00 per barrel.

In order to hedge the fluctuation in the market value of the oil, the company signs a futures contract on the same date to deliver 100,000 barrels of oil on 31 March 20X3 at a futures price of $27.50 per barrel. The conditions for hedge accounting were met.

Due to unexpected increases in production, the market price of oil on 31 December 20X2 was $22.50 per barrel and the futures price for delivery on 31 March 20X3 was $23.25 per barrel at that date.

Requirement

Explain the impact of the transactions on the financial statements of the company for the year ended 31 December 20X2.

2 Columba

The Columba Company has hedged the cash flows relating to its interest rate risk by purchasing an interest rate cap. The conditions for hedge accounting were met.

Additional interest charges up to the end of the financial year amount to £17,000 while the fair value of the interest rate cap increased by £20,000.

Requirement

What amount relating to the interest rate cap should be recorded in profit or loss?

3 Pula

The Pula Company manufactures heavy engineering equipment which it sells in many countries throughout the world. The functional currency of Pula is the pound (£).

On 1 November 20X7 Pula entered into a contract with the Roadmans Company, whose functional currency is the N$, to sell a bulldozer for delivery on 1 April 20X8. The contract price is fixed in N$.

Also on 1 November 20X7, Pula entered into a foreign currency forward contract to hedge its future exposure to changes in the £:N$ exchange rate, arising from the contract with Roadmans.

The conditions for hedge accounting were met.

Requirement

What designations are available to Pula in respect of the hedging arrangement?

4 JayGee

On 1 August 20X1, JayGee entered into a non-cancellable purchase order to acquire equipment from Zenda Corporation, a Ruritanian entity, at 300 million rurits (Ru). Payment is made upon delivery of the equipment to the UK on 31 December 20X1. On 30 September 20X1, JayGee entered into a forward contract to exchange Ru 300 million at a pre-determined exchange rate between the rurit and pound sterling on 31 December 20X1. The functional currency of JayGee is the pound sterling (£).

Requirement

Discuss the accounting implications for the purchase contract and forward contract if fair value hedge accounting is adopted.

5 Tried & Tested plc

You are a senior in the firm that acts as auditors and advisers to Tried & Tested plc (T&T). The finance director of T&T is proposing to restructure the company's loans to find cheaper sources of finance, because she thinks that the company's financial gearing is too high in relation to its uncertain cash inflows. The engagement partner has attended a meeting with the finance director and has obtained the following information.

T&T: Notes of meeting

- T&T has completed 2 years of a 10-year 8.5% fixed-rate mortgage on its premises amounting to £2.5 million, and it is on this loan that the finance director is looking to reduce interest costs.
- T&T's bank has indicated that it could swap the interest charges on its loan with another of its customers, LeytonPlus plc (LP), which wishes to fix its interest liabilities in view of uncertain interest rate prospects.
- LP has a floating rate loan of £3.8 million on which it currently pays SONIA + 2.0%.

The swap agreement

Because of its higher credit rating T&T has negotiated that it should pay LP at a rate of SONIA + 1.0% as its contribution to the swap. For its part LP would pay 8.8% fixed to T&T. The bank will charge T&T 0.04% per annum of the swap value for the service. The swap agreement would last for 5 years and would be for £2.5 million (assume the current SONIA to be 6%).

Other credit facilities

LP and T&T have additional loan facilities available to them as follows:

- LP can obtain fixed rate loans at 10% per annum for up to 20 years.
- T&T can obtain floating rate loans at SONIA + 1.0%.

You have been sent the following note by the engagement partner.

On the basis of my meeting notes please draft notes covering the following issues:

- The audit and assurance issues regarding the swap arrangement including an assessment of whether the proposed swap may be designated a hedge.
- The control structure you would expect to be in place to manage the risks associated with the swap.
- The finance director has had little experience of swap agreements, and requires confirmation of the net reduction in annual interest costs to T&T if the swap is agreed. Please produce this calculation.

Requirement

Respond to the partner's note.

6 Anew plc

Anew plc (Anew), a client of your firm, has recently established a treasury and investment division within its existing business. The division deals in derivatives, in addition to other treasury and investment instruments, for both trading and hedging purposes. Most of the company's derivative trading activities relate to sales, positioning and arbitrage. Sales activities involve offering products to customers and banks in order to enable them to transfer, modify or reduce current and future risks.
Positioning involves managing market risk positions with the expectation of profiting from favourable movements in prices, rates or indices. Arbitrage involves profiting from price differentials between markets or products.

The company has adopted a comprehensive system for the measurement and management of risk. Part of the risk management process involves managing the company's exposure to fluctuations in foreign exchange and commission rates, to reduce exposure to currency and commission rate risks to acceptable levels as determined by the board of directors within the guidelines issued by the Central Bank. The company uses different types of derivatives, including swaps, forwards and futures, forward rate agreements, options and swaptions.

Requirements

6.1 In planning the audit of Anew, identify and explain five key risks that may arise from the derivatives trading activities that the newly formed division is involved in.

6.2 Identify and explain the general controls and application controls which you consider necessary for ensuring that these risks are controlled appropriately.

6.3 You have as one of the assistants on the audit Melanie, who has just completed the professional level examinations. She has asked you for a briefing note on "how to distinguish derivatives activity for trading purposes from derivatives activity for hedging purposes, and how these are accounted for and audited within the international accounting and auditing framework".

Requirement

In response to this request and considering that Melanie's main interest is in the audit of these instruments, draft a memorandum to Melanie providing her with the advice she requires, clarifying any ambiguous phrases in her request.

Your memorandum should be structured under the following headings.

- Derivative instruments
- Use of derivatives for trading purposes
- Use of derivatives for hedging purposes
- The audit of derivative instruments

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

1.1 **Explanation**

This forward contract is a **derivative**. It is a **financial liability** because it is **unfavourable** at the year end.

Under the forward contract, BCL has to pay £3.125 million ($2m ÷ 0.64).

At the year end, an equivalent contract would only have cost £2.857 million ($2m ÷ 0.7).

Therefore, the contract is standing at a loss of £0.268 million (£3.125m – £2.857m) at the year end. This is why it is a financial liability.

Normally derivatives are treated as being **held for trading**, so this contract will be treated as a **financial liability at fair value through profit or loss**. Journal entry:

DEBIT	Profit or loss	£0.268m	
CREDIT	Financial liability		£0.268m

Being the recognition of the liability and loss on forward contract

1.2

(a) **Recording the gain or loss**

If the forward contract is to be treated as a hedging instrument, it should still be measured at its fair value of £0.268 million but the loss should be recognised in **other comprehensive income** instead of profit or loss.

Why different treatment is necessary

The reason for hedging is to try to **offset the gain/loss on the hedged item** with the **corresponding loss/gain on the hedging instrument**.

With a **cash flow hedge**, the hedged item is often a future or forecast transaction that has not yet been recorded in the financial statements. If the normal accounting treatment was applied, the loss on this hedging instrument would be recognised in profit or loss in one period and the gain on the hedged item would be recognised in profit or loss in a later period, so the offsetting effect would not be reflected.

When the gain on the hedged item occurs and is recognised in profit or loss, the loss on the forward contract should be **reclassified** from other comprehensive income to profit or loss. This matches the gain and loss and better reflects the offsetting that was the purpose of the transaction.

(b) **Extract from statement of profit or loss and other comprehensive income for the year ended 31 August 20X0**

	£m
Profit for the year	1.000
Other comprehensive income	
Loss on forward contract	(0.268)
Total comprehensive income	0.732

(a) **Initial recognition**

DEBIT	Investment in equity instruments	£112,560	
CREDIT	Bank		£112,560

Being the initial recognition of investment in equity instruments at fair value, including transaction costs (W1).

Measurement at 31 July 20X3

DEBIT	Investment in equity instruments	£5,840	
CREDIT	Other comprehensive income		£5,840

Being the gain on remeasurement of the investment in equity instruments (W2). (The gain will be recognised in other components of equity.)

WORKINGS

(1) **Fair value March 20X3**

	£
Fair value (40,000 shares @ £2.68)	107,200
Commission (5% × 107,200)	5,360
	112,560

(2) **Gain to 31 July 20X3**

	£
Fair value (40,000 shares @ £2.96)	118,400
Previous value	(112,560)
	5,840

(b) Discussion as follows:

Fair value hedge

The entity has elected under IFRS 9 to recognise gains and losses on investments in equity instruments in **other comprehensive income** and the gain or loss on a derivative is recognised in **profit or loss**.

However, assuming that the derivative meets the criteria to be treated as a hedging instrument, it would be treated as a **fair value hedge.** This means that:

- the gain or loss on the investment in equity instruments (the 'hedged item') would be taken to **other comprehensive income**; and
- this would be offset by the corresponding loss or gain on the derivative, also in other comprehensive income (IFRS 9.5.8).

This treatment is a fair reflection of the economic substance of the hedging arrangement, where the intention is that the changes in value of the derivative will cancel out the changes in value of the hedged item.

Answer to Interactive question 3

The credit default swap (CDS) is recognised as a derivative at fair value through profit or loss. IFRS 9 allows fair value option for a proportion of the loan commitment. If this option is elected, then £500,000 of the loan commitment is accounted for at fair value through profit or loss and, as a result, provides an offset to the fair value through profit or loss on the CDS.

(a) The futures contract was intended to protect the company from a fall in oil prices (which would have reduced the profit when the oil was eventually sold). However, oil prices have actually risen, so that the company has made a loss on the contract.

Without hedge accounting

The futures contract is a derivative and therefore should be remeasured to fair value under IFRS 9. The loss on the futures contract should be recognised in profit or loss:

DEBIT	Profit or loss (40,000 × [£24 – £22])	£80,000	
CREDIT	Financial liability		£80,000

(b) **With hedge accounting**

The loss on the futures contract should be recognised in profit or loss, as before. There is an increase in the fair value of the inventories:

	£
Fair value at 31 December 20X3 (40,000 × £22.25)	890,000
Fair value at 1 December 20X3 = cost	(800,000)
Gain	90,000

The gain should also be recognised in profit or loss and adjusted against the carrying amount of the inventories:

DEBIT	Inventory	£90,000
CREDIT	Profit or loss	£90,000

The net effect on profit or loss is a gain of £10,000 compared with a loss of £80,000 without hedging.

Answer to Interactive question 5

The hedge is fully effective, as the gain on the hedging instrument is less than the loss on the cash flows. The total gain of £8,800 is therefore recognised in other comprehensive income. The double entry is:

DEBIT	Hedging instrument (SOFP)	£8,800	
CREDIT	Other comprehensive income		£8,800

Answer to Interactive question 6

No. A cash flow hedge is defined as a hedge of the exposure to variability in cash flows attributable to a particular risk. In this case, the issued debt instrument does not give rise to any exposure to volatility in cash flows since the interest is calculated at a fixed rate.

The entity may designate the swap as a fair value hedge of the debt instrument, but it cannot designate the swap as a cash flow hedge of the future cash outflows of the debt instrument.

Answer to Interactive question 7

No. The FRA does not qualify as a cash flow hedge of the cash flow relating to the fixed rate assets because they do not have a cash flow exposure.

The entity could, however, designate the FRA as a hedge of the fair value exposure that exists before the cash flows are remitted.

8.1 IFRS 9 allows both of these two methods.

If the hedge is treated as a fair value hedge, the gain or loss on the fair value remeasurement of the hedging instrument and the gain or loss on the fair value remeasurement of the hedged item for the hedged risk should be recognised immediately in profit or loss.

8.2 If the hedge is treated as a cash flow hedge, the portion of the gain or loss on remeasuring the forward contract that is an effective hedge should be recognised in other comprehensive income. The amount should be reclassified in profit or loss in the same period or periods during which the hedged item (the liability) affects profit or loss ie, when the liability is remeasured for changes in foreign exchange rates. Therefore, if the hedge is effective, the gain or loss on the derivative is released to profit or loss in the same periods during which the liability is measured, not when the payment occurs.

Answer to Interactive question 9

The entity does have this choice.

If the entity designates the foreign exchange contract as a fair value hedge, the gain or loss from remeasuring the forward exchange contract at fair value is recognised immediately in profit or loss, and the gain or loss on remeasuring the receivable is also recognised in profit or loss.

If the entity designates the foreign exchange contract as a cash flow hedge of the foreign currency risk associated with the collection of the receivable, the portion of the gain or loss that is determined to be an effective hedge should be recognised in other comprehensive income, and the ineffective portion in profit or loss. The amount held in equity should be reclassified to profit or loss in the same period or periods during which changes in the measurement of the receivable affect profit or loss.

Answer to Interactive question 10

Given that RapidMart is hedging the volatility of the future cash outflow to purchase fuel, the forward contract is accounted for as a cash flow hedge, assuming all the criteria for hedge accounting are met (ie, the hedging relationship consists of eligible items, designation and documentation at inception as a cash flow hedge, and the hedge effectiveness criteria are met).

At inception, no entries are required as the fair value of a forward contract at inception is zero. However, the existence of the hedge is disclosed under IFRS 7, *Financial Instruments: Disclosures*.

At the year end, the forward contract must be valued at its fair value of £0.12 million as follows. The gain is recognised in other comprehensive income (items that may subsequently be reclassified to profit or loss) in the current year as the hedged cash flow has not yet occurred. This will be reclassified to profit or loss in the next accounting period when the cost of the diesel purchase is recognised.

WORKING

	£m
Market price of forward contract for delivery on 31 December (1m × £2.16)	2.16
RapidMart's forward price (1m × £2.04)	(2.04)
Cumulative gain	0.12

The gain is recognised in other comprehensive income as the cash flow has not yet occurred:

DEBIT	Forward contract (financial asset in SOFP)	£0.12m
CREDIT	Other comprehensive income	£0.12m

Foreign currency receivables

	£'000
Receivable originally recorded (30,240/5.6)	5,400
Receivable at year end (30,240/5.4)	5,600
Exchange gain	200

		£'000	£'000
DEBIT	Trade receivables	200	
CREDIT	Profit or loss (other income)		200

Forward contract

This is a cash flow hedge:		£'000	£'000
DEBIT	Other comprehensive income	200	
DEBIT	Finance cost (forward points)	20	
CREDIT	Financial liability		220

As the change in cash flow affects profit or loss in the current period, a reclassification adjustment is required (£'000):

		£'000	£'000
DEBIT	Profit or loss	200	
CREDIT	Other comprehensive income		200

Answer to Interactive question 12

Cash flow hedge

Value of contract:	£'000
Price at 31 December 20X2 (3,000 × 1,400)	4,200
Price at 1 November 20X2 (3,000 × 1,440)	(4,320)
Loss	(120)

		£'000	£'000
DEBIT	Other comprehensive income	120	
CREDIT	Financial liability		120

The tax treatment follows the treatment in the IFRS Standard. However, the current tax credit has not yet been recorded. This is credited to other comprehensive income rather than profit or loss, as the loss itself on the contract is recognised in other comprehensive income (IAS 12.61A):

		£'000	£'000
DEBIT	Current tax liability (SOFP) (120 × 30%)	36	
CREDIT	Income tax credit (OCI)		36

The purpose of the forward contract is to hedge the fair value of the recognised receivable due to fluctuations in exchange rates. It is therefore a fair value hedge.

Providing relevant documentation has been set up, which appears to be the case here, hedge accounting rules can be used provided that:

- the hedge is expected to be highly effective at achieving offsetting changes in fair value;
- the effectiveness of the hedge can be reliably measured; and
- the hedge is assessed to actually have been highly effective.

The foreign currency receivable will initially be recognised at the spot rate at the date of the transaction ie, at USD1,614,205 (GBP 1 million/0.6195).

At 31 December 20X1, the receivable is restated in accordance with IAS 21 to USD1,554,002 (GBP 1 million/0.6435). A loss of USD60,203 ($1,614,205 – $1,554,002) is therefore recognised in profit or loss.

The forward contract is recognised in the financial statements at 31 October 20X1. However, no double entries are recorded, as the value of a forward contract at inception is zero.

However, recognition of the hedge will trigger disclosure under IFRS 7 as follows:

- A description of the hedge
- A description of the forward contract designated as a hedging instrument
- The nature of the risk being hedged (ie, change in exchange rates affecting the fair value of the receivable)
- Gains and losses on the hedging instrument and the hedged item

At 31 December 20X1, the change in fair value of the forward contract is recognised in profit or loss as this is a fair value hedge:

	$
[(–1mGBP/0.6440 + (1mGBP/0.6202)) × (1/1.00325$^{1/12}$)]	59,572
At 31 October 20X1 (zero at inception)	(0)
Change in fair value of forward contract (gain)	59,572

The company has designated changes in the spot element of the forward contract as the hedge. The change in the spot element is:

	$
[(–1mGBP/0.6435 + (1mGBP/0.6195)) × (1/1.00325$^{1/12}$)]	60,187
At 31 October 20X1 (zero at inception)	(0)
Change in fair value of spot element of forward contract (gain)	60,187

Effectiveness of the hedge is calculated as:

(Cumulative change in fair value of spot element of hedging instrument/Cumulative change in fair value of hedged item)

= ($60,187/($60,203*) = 99.97% (or 100.03% if measured the other way around)

* If the effect of discounting short-term receivables to obtain a more precise fair value is taken into account, this could be measured at $60,187 giving effectiveness of exactly 100%.

The hedge is measurable and effective. Therefore hedge accounting can be used, assuming the hedge is expected to be highly effective until 31 January 20X2.

The interest element (which arises due to different interest rates between the currencies of the forward contract) is excluded from the hedging relationship and recognised as a finance cost:

		$	$
DEBIT	Forward contract	59,572	
DEBIT	Finance costs (P/L) (60,187 – 59,572)	615	
CREDIT	Profit or loss		60,187

Profit or loss:	$
Loss on foreign currency receivable	(60,203)
Gain on hedging instrument	60,187
Finance costs	(615)

Statement of financial position

Current assets	**$**
Trade receivables (1,614,205 – 60,203)	1,554,002
Forward contract hedging instrument	59,572

Answer to Interactive question 14

14.1 **Issues**

The treatment of the debenture does not appear to comply with accounting standards. It should be treated as a hybrid instrument, split into its equity and liability components. Normally the liability component should be calculated as the discounted present value of the cash flows of the debenture, discounted at the market rate of interest for a comparable borrowinWg with no conversion rights. The remainder of the proceeds represents the fair value of the right to convert and this element should be reclassified as equity.

14.2 **Procedures**

- Obtain a copy of the debenture deed and agree the nominal interest rate and conversion terms
- Assuming the revised treatment is adopted, review schedule calculating the fair value of the liability at the date of issue. Confirm that an appropriate discount rate has been used (ie, market rate of interest for a comparable borrowing with no conversion rights)
- Agree initial proceeds and interest payment to cash book and bank statement
- Review adequacy of disclosures in accordance with accounting standards

Answer to Interactive question 15

15.1 There are no accounting entries at the inception of the forward contract.

On 31 December 20X7, there is an increase in derivative asset (increase in fair value of forward contract) of £500,000 and this is reflected in profit or loss as a gain.

On 31 December 20X8, there is a decrease in derivative asset of £100,000 and this is reflected as a loss in profit or loss for the year.

15.2 As illustrated in part 1, one of the risks is that the fair value of the asset will go down. This is referred to as market risk – a risk relating to the adverse changes in the fair value of the derivative; in this case the forward contract. This is a very real risk for J.

There is foreign exchange risk. This is the risk that J's earnings will be affected as a result of fluctuations in currency exchange rates. J's functional currency is GBP but crude oil prices are quoted in the USD. The movement in the £/$ exchange rate will affect J's earnings arising from this contract.

There is credit risk – the risk that the counterparty will not settle the obligation at full value.

There is the related settlement risk – the risk that settlement will take place without J receiving value from the counterparty.

Solvency risk is the risk that J will not have the funds to settle when the payment for the barrels becomes due. This may be related to the market risk described above.

There is also interest rate risk. This is the risk that J will suffer loss as a result of fluctuations in the value of the forward contract due to changes in market interest rates. If the movement in interest rates is such that the price of crude goes down then J will be affected adversely.

As auditor, I would need to do the following:

- Assess the audit risk and design audit procedures to ensure that risk is reduced to an acceptable level.
- Understand J's accounting and internal control system to enable me to assess whether it is adequate to deal with forward contracts of this type specifically, but also with any type of derivatives J carries out, generally. I would need to assess the control environment to ensure that it is strong enough and that J has clear control objectives in place. Control objectives would include authorised execution of the deal, checking completeness and accuracy of the information, prevention and detection of errors, appropriate accounting for changes in the value of the derivative (the forward contract), and general ongoing monitoring.
- Confirm that appropriate reconciliations are carried out and that there are appropriate controls around the reconciliations. The reconciliations would include:
  - the one between the dealer's deal sheet and the back office records used for the ongoing monitoring process; the one between the clearing and bank accounts and the broker statements to ensure that all outstanding items are identified and promptly cleared; and the one between J and the appropriate brokers and agents.
- Verify that data security procedures are adequate to ensure recovery in the case of disaster by reference to either IT staff or via observation of suitable back-up procedures.
- I would carry out procedures to ensure that the amounts recorded at the year ends (31 December 20X7 and 31 December 20X8) are appropriate. These would include:
  - inspecting the agreement for the forward contract and the supporting documentation to ensure that the agreement occurred (at 31 December 20X7 only) and confirming that the situation has not changed subsequently;
  - inspecting documentation for evidence of the purchase price (at 31 December 20X7 only); and
  - obtaining evidence collaborating the fair value of the forward contract; for example quoted market prices.

15.3 I would confirm that the following IFRS 7 disclosures have been made.

- The accounting policy for financial instruments including forwards, especially how fair value is measured.
- Net gains to be recorded in profit or loss (£500,000 for year ending 31 December 20X7) and net losses (£100,000 for year ending 31 December 20X8).
- The fair value of the asset category which includes the forward contract. The disclosure should be such that it permits the information to be compared with the corresponding carrying amount.
- The nature and extent of risks arising from financial instruments, including forward contracts. The disclosures should be both qualitative and quantitative.

Answers to Self-test questions

1 Hedging

The futures contract was entered into to protect the company from a fall in oil prices and hedge the value of the inventories. It is therefore a fair value hedge.

The inventories should be recorded at their cost of $2,600,000 (100,000 barrels at $26) on 1 July 20X2.

The futures contract has a zero value at the date it is entered into, so no entry is made in the financial statements.

Note: However, the existence of the contract and associated risk would be disclosed from that date in accordance with IFRS 7.

At the year end the inventories should be measured at the lower of cost and net realisable value. Hence they should be measured at $2,250,000 (100,000 barrels at $22.50) and a loss of $350,000 recognised in profit or loss.

However, a gain has been made on the futures contract:

	$
The company has a contract to sell 100,000 barrels on 31 March 20X3 at $27.50	2,750,000 A
contract entered into at the year end would sell these barrels at $23.25 on 31 March 20X3	2,325,000
Gain (= the value the contract could be sold on for to a third party)	425,000

The gain on the futures contract should also be recognised in profit or loss:

DEBIT	Future contract asset	$425,000	
CREDIT	Profit or loss		$425,000

The net effect on profit or loss is a gain of $75,000 ($425,000 less $350,000), whereas without the hedging contract there would have been a loss of $350,000.

Note: If the fair value of the inventories had increased, the carrying amount of the inventories should have been increased by the same amount and this gain also recognised in profit or loss (normally gains on inventories are not recognised until the goods are sold). A loss would have occurred on the futures contract, which should also have been recognised in profit or loss.

2 Columba

A gain of £3,000 should be recognised in profit or loss.

The ineffective portion of the gain or loss on the hedging instrument should be recognised in profit or loss. In a cash flow hedge the amount to be recognised in other comprehensive income is the lower of:

- the cumulative gain/loss on the hedging instrument ie, £20,000; and
- the cumulative change in fair value of the hedged item ie, £17,000.

So £17,000. This leaves £3,000 of the increase in the fair value of the cap to be recognised in profit or loss.

3 Pula

The hedging relationship may be designated **either** a fair value hedge **or** a cash flow hedge.

The contract to sell the bulldozer represents a firm commitment with Roadmans, not merely a proposed transaction, and it is expressed in a currency other than Pula's functional currency. A hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge.

4 JayGee

If JayGee designates the hedge as a fair value hedge, the non-cancellable purchase order in rurits is considered as a firm commitment to be hedged (hedged item) in connection with the spot foreign currency risk.

The rurit forward contract is considered to be the hedging instrument.

As a financial derivative, the rurit forward contract will have been reported at fair value on each reporting date, with gains or losses reported in profit or loss.

Under a fair value hedge, the change in fair value of the firm commitment related to the hedged risk will also be recognised in profit or loss and adjusts the carrying amount of the hedged item. This applies if the hedged item is otherwise measured at cost. For JayGee's hedged item, which is an unrecognised firm commitment, its cumulative change in the fair value attributable to the hedged risk is recognised as an asset or liability.

5 Tried & Tested plc

Audit and assurance issues Assessment of proposed swap

- The hedging relationship qualifies for hedge accounting only if all the following conditions are met:
  - (a) At the inception of the hedge there is formal designation and documentation of the hedging relationship, and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.
  - (b) The hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.
  - (c) For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.
  - (d) The effectiveness of the hedge can be reliably measured ie, the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured.
  - (e) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

Other audit and assurance issues

- This is a relatively complex transaction which will increase audit risk, particularly as the finance director has had little experience of this type of transaction before.

- T&T is exposed to interest rate risk if the swap goes ahead. T&T has changed its fixed interest commitments to variable commitments. It is possible that interest rates will rise, particularly as interest rates are said to be uncertain.
- Since T&T has a better credit rating, it is possible that it may face risk of default from LP on the loan payments under the swap agreement.
- The finance director is concerned about the level of gearing within the company. While steps are being taken to deal with the situation, this issue will need to be considered as part of the going concern review.
- The extent to which the bank will be expecting to place reliance on financial information as part of the process of agreeing the swap and any specific assurances which we might be required to provide.

6 Anew plc

6.1 Reduction in annual interest costs

Variable rate interest liabilities and income for T&T

	%
Interest on fixed loan currently paid	8.5
Received from LP under swap agreement	(8.8)
Difference	(0.3)
Payment by T&T to LP under swap agreement (SONIA + 1)	6 + 1.0
Total variable payments by T&T	6.7

This is a 0.3% reduction on its SONIA facilities.

	£	£
T&T currently pays – fixed (8.5% × £2.5m)		212,500
Will pay		
Interest (6.7% × £2.5m)	167,500	
Bank charge (0.04% × £2.5m)	1,000	
		(168,500)
Net annual saving		44,000

6.2 Necessary general controls and application controls

Note: This answer assumes that a computer system is used in processing trades involving derivatives.

General controls

A number of general controls may be relevant in this case, for example the following:

- For credit risk, general controls may include ensuring that off-market derivative contracts are only entered into with counterparties from a specific list and establishing credit limits for all customers.
- For legal risk, a general control may be to ensure that all transactions are reviewed by properly qualified lawyers and regulation specialists.
- For market risk, a general control may be to set strict investment acceptance criteria and ensure that these are adhered to.
- For settlement risk, a general control may be to set up a third party through whom settlement takes place, ensuring that the third party is instructed not to give value until value has been received.

- For solvency (liquidity) risk, general controls may include having diversified funding sources, managing assets with liquidity in mind, monitoring liquidity positions, and maintaining a healthy cash and cash equivalents balance.

Application controls

These include the following:

- A computer application may identify the credit risk. In this case, an appropriate control may be monitoring credit exposure, limiting transactions with an identified counterparty and stopping any further risk-increasing transactions with that counterparty.
- For legal risk, an application control may be the system insisting that it will not process a transaction/trade until an authorised person has signed into the system to give the authority. Such an authorised person may be different depending on the nature and type of transaction. In some cases it may be the company specialist solicitor; yet in other cases it may just be the dealer's supervisor.
- For market risk, an application control may carry out mark to market activity frequently and the production of timely exception management reports.
- For settlement risk, an application control may be a computer settlement system refusing to release funds/assets until the counterparty's value has been received, or an authorised person has confirmed to the system that there is evidence that value will be received.
- For solvency risk, an application control may be that the system will produce a report for management informing management that there needs to be a specific amount of funds available on a given date to settle the trades coming in for settlement on that date.

6.3 Memorandum

To Melanie

From Jane Chadge

Date 12 November 20X7

Subject Briefing note on all manner of things derivative

Thank you for your recent email asking me to explain how to distinguish derivatives activity for trading purposes from derivatives activity for hedging purposes. In the same email you asked me to explain how these instruments are accounted for and audited within the international accounting and auditing framework. In this briefing note, I am assuming that your reference to international accounting and auditing framework is to IFRS Standards/IAS Standards (International Financial Reporting Standards/International Accounting Standards) and ISAs (International Standards on Auditing UK) for Accounting and Auditing respectively. I am also assuming that '… **for trading purposes** 'refers to engagement in derivatives activity for speculative purposes.

Derivative instruments

- These are financial contracts between two parties where payments are dependent on movements in price in one or more underlying financial instruments, reference rates or indices.
- They are financial instruments or other contracts within the scope of relevant accounting standards. IAS 32, IFRS 9 and IFRS 7 deal with the accounting and disclosure requirements for derivatives.
- IFRS 9 requires that derivatives be measured at fair value in the statement of financial position unless they are linked to, and must be settled by, an investment in an unquoted equity instrument that cannot be reliably measured at fair value.
- In general, derivatives can be used either for speculation (trading) or for hedging (offsetting risk). How the derivative is accounted for and disclosed will depend on whether it is for speculative or hedging purposes.

- Generally, a derivative instrument can be any instrument that has the three characteristics stated in IFRS 9. Derivative instruments include swaps, options, swaptions, forwards and futures. A derivative instrument can be embedded in another (non-derivative) instrument; for example, a company issuing a bond whose interest is linked to the USD price of crude oil, such that the interest payments increase and decrease with this price.

Use of derivatives for trading purposes

- Speculators may trade with other speculators as well as with hedgers. In most financial derivatives markets, the value of speculative trading is far higher than the value of true hedge trading.
- As well as outright speculation, derivatives traders may look for arbitrage opportunities between different derivatives on identical or closely related underlying securities.
- Derivatives such as options, futures or swaps generally offer the greatest possible reward for betting on whether the price of an underlying asset will go up or down. For example, a person may believe that an oil company may find more oil reserves in the next year. If the person bought the stock (share) for £10, and it went to £20 after the discovery was announced, the person would have made a profit and have a return on his investment.
- Other uses of derivatives are to gain an economic exposure to an underlying security in situations where direct ownership of the underlying security is too costly or is prohibited by legal or regulatory restrictions, or to create a synthetic short position. In addition to directional plays (ie, simply betting on the direction of the underlying security), speculators can use derivatives to place bets on the volatility of the underlying security. This technique is commonly used when speculating with traded options.

The audit of derivative instruments

- For many entities, the use of derivatives has reduced exposure to changes in exchange rates, interest rates and commodity prices and other risks.
- The inherent characteristics of derivatives usually result in increased financial risk, in turn increasing audit risk and presenting the auditor with new challenges.
- To audit derivatives adequately, the auditor needs to:
  - have specialist skills and knowledge. In the case of Anew the auditor will need to understand the operating characteristics and risk profile of the industry in which Anew operates, the characteristics of the specific derivative used, Anew's derivatives information system, how Anew values derivatives and reporting requirements of IFRS 9 and IFRS 7;
  - know the business including industrial sector issues, political, economic, sociocultural and technological factors, the strengths and weaknesses of Anew (eg, experience of management and those charged with governance), and the reasons for using specific derivatives (in this case both speculative and risk management);
  - identify the key risks (as already identified);
  - assess the risk and the internal controls in accordance with ISA (UK) 315 (Revised July 2020), *Identifying and Assessing the Risks of Material Misstatement*;
  - identify internal controls (and test those controls identified to check if they are 'fit for purpose';
  - carry out substantive procedures to ensure that key assertions, as identified in ISA 315, are met. These key assertions relate to existence and occurrence, rights and obligations, completeness, accuracy, valuation and allocation, and presentation. These would have to be considered for all material derivatives; and
  - handle non-standard derivatives according to the circumstances ensuring that control and substantive tests have been carried out as appropriate.

I trust that the above points have provided you with the information you require. Please do not hesitate to seek further clarification on any of these points.

Chapter 18

Employee benefits

Introduction

Learning outcomes

- Explain how different methods of providing remuneration for employees may impact upon reported performance and position
- Explain and appraise accounting standards that relate to employee remuneration which include different forms of short-term and long-term employee compensation; retirement benefits; and share-based payment
- Justify and conclude for a particular scenario what comprises sufficient, appropriate audit evidence
- Design and determine audit procedures in a range of circumstances and scenarios, for example identifying an appropriate mix of tests of controls, analytical procedures and tests of details
- Demonstrate and explain, in the application of audit procedures, how relevant ISAs affect audit risk and the evaluation of audit evidence

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive Question
1	**Objectives and scope of IAS 19, *Employee Benefits*** This very short section introduces the standard and states that it is structured as follows: • Short-term employee benefits • Post- employment benefits • Other long-term employee benefits • Termination benefits	**Approach** Employee benefits is one of two chapters addressing employee remuneration. It is a new and complex topic to which you will need to devote a significant amount of time. Section 1 gives a summary of the types of benefits that the standard addresses. **Stop and think** Share-based payments are excluded because they are the subject of a separate standard.	Although IAS 19 is frequently examined, you will not be tested just on this introductory material.	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive Question
2	**Short-term employee benefits** Employee benefit costs can be a very significant proportion of total expenses. Accounting for short-term benefits presents few, if any, problems.	**Approach** The accounting for short-term employee benefits is relatively straightforward. The application of the accruals concept in relation to liabilities means that a short-term benefit should be recognised as an employee provides the services to the entity on which the benefits are payable. **Stop and think** Consider what short-term benefits are offered in your workplace.	The most common short-term benefits that have been tested are bonuses and holiday pay. Both could be tested in an integrated way. In the case of bonuses, ethical issues could arise.	N/A
3	**Post-employment benefits overview** This section introduces the concept of defined contribution (money purchase) and defined benefit (final salary) plans.	**Approach** Read carefully, using the diagrams in sections 3.1 and 3.2 to aid your understanding. **Stop and think** Why are defined benefit plans more risky than defined contribution plans?	This overview is unlikely to be tested directly in an exam – it is there for background only.	N/A
4	**Defined contribution plans** You will need to be able to apply the requirements of IAS 19 to the relatively straightforward defined contribution plans.	**Approach** The key points are: Recognise contributions payable as an expense in the period in which the employee provides services Recognise a liability where contributions remain unpaid at the period end. Study the worked example carefully. **Stop and think**	Defined contribution plans have been tested occasionally but you are more likely to be asked about defined benefit plans.	am

Topic	Practical significance	Study approach	Exam approach	Interactive Question
		Why are defined contribution plans becoming more common?		
5	**Defined benefit plans – recognition and measurement** The cost of long-term and post-employment benefits, which include pension plans, medical benefits and life insurance, is difficult to estimate. The entity must rely on the expertise of actuaries.	**Approach** Make sure you understand the main issue in 5.1 – the plan may be in surplus or deficit and the contributions will vary accordingly. Paragraphs 5.4 (movement in defined benefit plan) and 5.5 (four- step method) are the most important. **Stop and think** What discount rate should be used?	IAS 19 is new at Advanced Level and is examined very frequently. The movement on the asset or liability is often tested in a scenario where the company has failed to do this properly and treated the plan like a defined contribution plan.	N/A
6	**Defined benefit plans – other matters** This section deals with past service costs, curtailments, settlements and the asset ceiling test.	**Approach** Past service costs arise from plan amendments, for example increasing the benefits payable. They usually increase the obligation, but may reduce it. Remeasure the obligation first. Learn the suggested approach in Section 6.5 – this will cover most situations in the exam. **Stop and think** What is the asset ceiling?	Curtailments and past service costs have been examined regularly, sometimes interacting with deferred tax.	**IQ1: Defined benefit 1** This is a comprehensive question covering the movement on the asset or liability over three years with a settlement and an additional payment. You should do all four interactive questions in this section.
7	**Defined benefit plans – disclosure** The main disclosures include a description of the plan, a reconciliation of the fair value of plan assets from the	**Approach** Read through this section, but remember you can always look it up in the open book, should it be examined.	This topic has yet to be examined.	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive Question
	opening to closing position, the actual return on plan assets, a reconciliation of movements in the present value of the defined benefit obligation during the period, an analysis of the total expense recognized in profit or loss, and the principal actuarial assumptions made.	**Stop and think** Why do we have to disclose key assumptions and methods used in the accounting for defined benefit pension plans?		
8	**Other long-term employee benefits** Examples include paid sabbaticals and long-term sick leave.	**Approach** Read through quickly. **Stop and think** Where are actuarial gains and losses recognised?	This area has not yet been examined.	N/A
9	**Termination benefits** These are payments to encourage voluntary redundancy or payments before the normal retirement date.	**Approach** Read through quickly. **Stop and think** Recognise a termination benefit when there is a firm commitment to end the employment.	This has briefly been tested in the context of audit. Disclosures could also be tested.	N/A
10	**IAS 26, *Accounting and Reporting by Retirement Benefit Plans*** Retirement benefit plans must also prepare financial statements.	**Approach** Skim through quickly – this is examinable only at Level D. **Stop and think** What are net assets available for benefits?	This standard has not yet been examined.	**IQ5: Scope** This is a quick multiple choice question which should not take long.
11	**Audit focus** Retirement benefits are a challenge for auditors because of the degree of judgement and estimate involved, and the consequent risk.	**Approach** Do not neglect the audit focus section – pensions are a popular topic and as likely to come up in an integrated question as in a single silo FR	The audit of defined benefit schemes has been tested regularly, partly in the context of risk.	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive Question
		question. Learn the table in section 11.1. **Stop and think** The auditor must evaluate the appropriateness of fair value measurements, particularly in relation to plan assets.		

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Objectives and scope of IAS 19, *Employee Benefits*

Section overview

IAS 19 considers the following employee benefits:

- Short-term employee benefits
- Post-employment benefits
- Other long-term employee benefits
- Termination benefits

IAS 19, *Employee Benefits* should be applied by all entities in accounting for the provision of all employee benefits, except those benefits which are equity based and to which IFRS 2, *Share-based Payment* applies. The standard applies regardless of whether the benefits have been provided as part of a formal contract or an informal arrangement.

Employee benefits are all forms of consideration, for example cash bonuses, retirement benefits and private health care, given to an employee by an entity in exchange for the employee's services.

A number of accounting issues arise due to:

- the valuation problems linked to some forms of employee benefits; and
- the timing of benefits, which may not always be provided in the same period as the one in which the employee's services are provided.

IAS 19 is structured by considering the following employee benefits:

- Short-term employee benefits; such as wages, salaries, bonuses and paid holidays
- Post-employment benefits; such as pensions and post-retirement health cover
- Other long-term employee benefits; such as sabbatical and long-service leave
- Termination benefits; such as redundancy and severance pay

2 Short-term employee benefits

Section overview

Short-term employee benefits are those that fall due within 12 months from the end of the period in which the employees provide their services. The required accounting treatment is to recognise the benefits to be paid in exchange for the employee's services in the period on an accruals basis.

2.1 All short-term benefits

Definition

Short-term employee benefits: Employee benefits (other than termination benefits) that fall due within 12 months from the end of the period in which the employees provide their services.

Short-term employee benefits include the following:

(a) Wages, salaries and social security contributions

(b) Short-term absences where the employee continues to be paid, for example paid annual vacation, paid sick leave and paid maternity/paternity leave. To fall within the definition, the absences should be expected to occur within 12 months of the end of the period in which the employee services were provided

(c) Profit sharing and bonuses payable within 12 months of the end of the period

(d) Non-monetary benefits, for example private medical care, company cars and housing

The application of the accruals concept in relation to liabilities means that a short-term benefit should be recognised as an employee provides his services to the entity on which the benefits are payable. The benefit will normally be treated as an expense, and a liability should be recognised for any unpaid balance at the year end.

2.2 Short-term compensated absences

Definition

Short-term compensated absences: Compensated absences are periods of absence from work for which the employee receives some form of payment and which are expected to occur within 12 months of the end of the period in which the employee renders the services.

Examples of short-term compensated absences are paid annual vacation and paid sick leave.

Short-term compensated absences fall into two categories:

- **Accumulating absences**. These are benefits, such as paid annual vacation, that accrue over an employee's period of service and can potentially be carried forward and used in future periods; and
- **Non-accumulating absences**. These are benefits that an employee is entitled to, but are not normally capable of being carried forward to the following period if they are unused during the period, for example paid sick leave, maternity leave and compensated absences for jury service.

The cost of providing compensation for accumulating absences should be recognised as an expense as the employee provides the services on which the entitlement to such benefits accrues. Where an employee has an unused entitlement at the end of the reporting period and the entity expects to provide the benefit, a liability should be created.

The cost of providing compensation for non-accumulating absences should be expensed as the absences occur.

Worked example: Paid vacation

An entity has five employees and each is entitled to 20 days' paid vacation per year, at a rate of £50 per day. Unused vacation is carried forward to the following year.

At the year end, four of the employees have used their full holiday entitlement; the remaining one has four days' holiday to carry forward.

All five employees work for the entity throughout the year and are therefore entitled to their 20 days of vacation.

Requirement

How should the expense be recognised in the financial statements?

Solution

An expense should be recognised as part of staff costs for:

5 employees × 20 days × £50 = £5,000

Four of the employees use their complete entitlement for the year and the other, having used 16 days, is permitted to carry forward the remaining four days to the following period. A liability will be recognised at the period end for:

1 employee × 4 days × £50 = £200

2.3 Profit sharing and bonus plans

An entity should recognise an expense and a corresponding liability for the cost of providing profit- sharing arrangements and bonus payments when:

(a) the entity has a present legal or constructive obligation. The legal obligation arises when payment is part of an employee's employment contract. The constructive obligation arises where past performance has led to the expectation that benefits will be payable in the current period; and

(b) a reliable estimate of the obligation can be made.

Worked example: Bonus plan

An entity has a contractual agreement to pay a total of 4% of its net profit each year as a bonus. The bonus is divided between the employees who are with the entity at its year end. The following data is relevant:

Net profit	£120,000
Average employees	5
Employees at start of year	6
Employees at end of year	4

Requirement

How should the expense be recognised?

Solution

An expense should be recognised for the year in which the profits were made and therefore the employees' services were provided, for:

£120,000 × 4% = £4,800

Each of the four employees remaining with the entity at the year end is entitled to £1,200. A liability of £4,800 should be recognised if the bonuses remain unpaid at the year end.

Conditions may be attached to such bonus payments; commonly, the employee must still be in the entity's employment when the bonus becomes payable. An estimate should be made based on the expectation of the level of bonuses that will ultimately be paid. IAS 19 sets out that a reliable estimate for bonus or profit-sharing arrangements can be made only when:

- there are formal terms setting out determination of the amount of the benefit;
- the amount payable is determined by the entity before the financial statements are authorised for issue; or
- past practice provides clear evidence of the amount of a constructive obligation.

Worked example: Annual bonus

An entity with a 30 June year end has a past practice of paying an annual bonus to employees, although it has no contractual obligation to do so. Its practice is to appropriate 4% of its pre-tax profits, before charging the bonus, to a bonus pool and pay it to those employees who remain in employment on the following 30 September.

The total bonus is allocated to employees in proportion to their 30 June salaries, and amounts due to those leaving over the next three months are retrieved from the bonus pool for the benefit of the entity.

Past experience is that employees with salaries representing 8% of annual salaries leave employment by 30 September. The entity's pre-tax profits for the year ended 30 June 20X5 were £4 million.

Requirement

How should the bonus be recognised in the financial statements?

Solution

The bonus to be recognised as an expense in the year ended 30 June 20X5 is:

£4m × 4% × (100 – 8)% = £147,200

3 Post-employment benefits overview

Section overview

Post-employment benefits are employee benefits which are payable after the completion of employment.

These can be in the form of either of the following:

- Defined contribution schemes where the future pension depends on the value of the fund.
- Defined benefit schemes where the future pension depends on the final salary and years worked.

Definition

Post-employment benefits: Employee benefits (other than termination benefits) which are payable after the completion of employment. The benefit plans may have been set up under formal or informal arrangements.

Post-employment benefits include retirement benefits such as:

- pensions
- continued private medical care
- post-employment life assurance

There are two main types of post-employment benefit schemes:

- **Defined contribution schemes (money purchase schemes)**
- **Defined benefit schemes (final salary schemes)**

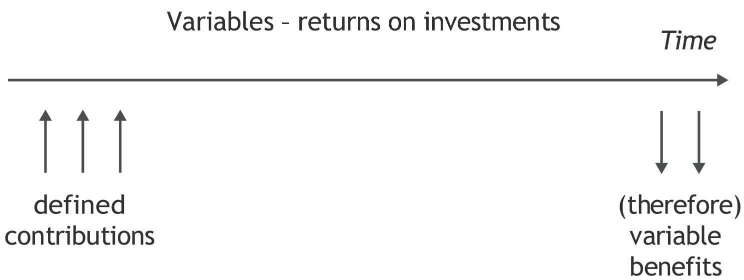
These two alternative schemes are discussed in more detail below.

A pension scheme will normally be held in the form of a trust separate from the sponsoring employer. Although the directors of the sponsoring company may also be trustees of the pension scheme, the sponsoring company and the pension scheme are separate legal entities that are accounted for separately. IAS 19 covers accounting for the pension scheme in the sponsoring company's accounts.

3.1 Defined contribution plans

Characteristics of a defined contribution plan are as follows:

- Contributions into the plan are fixed, normally at a percentage of an employee's salary.
- The amount of pension paid to retirees is not guaranteed and will depend on the size of the plan, which in turn depends on the performance of the pension fund investments.



Risk associated with defined contribution schemes

Contributions are usually paid into the plan by both the employer and the employee. The expectation is that the investments made will grow through capital appreciation and the reinvestment of returns and that, on a member's retirement, the plan should have grown to be sufficient to provide the anticipated benefits.

If the investments have not performed as anticipated, the size of the plan will be smaller than initially anticipated and therefore there will be insufficient assets to meet the expected benefits. This insufficiency of assets is described as the **investment risk** and is carried by the employee.

The other main risk with retirement plans is that a given amount of annual benefit will cost more than expected if, for example, life expectancy has increased markedly by the time benefits come to be drawn; this is described as the **actuarial risk** and, in the case of defined contribution plans, this is also carried by the employee.

Definitions

Investment risk: This is the risk that, due to poor investment performance, there will be insufficient funds in the plan to meet the expected benefits.

Actuarial risk: This is the risk that the actuarial assumptions such as those on employee turnover, life expectancy or future salaries vary significantly from what actually happens.

3.2 Defined benefit plans

Professional skills focus: Applying judgement

In the case of pension plans, particularly defined benefit plans, accountants and auditors need to rely on the judgement of actuaries, whose calculations may lie outside their field of expertise. In turn, the actuaries themselves may rely on assumptions from external parties about the future direction of the economy and other matters.

These are defined by IAS 19 as all plans other than defined contribution plans. Characteristics of a defined benefit plan are as follows:

- The amount of pension paid to retirees is defined by reference to factors such as length of service and salary levels (ie, it is guaranteed).
- Contributions into the plan are therefore variable depending on how the plan is performing in relation to the expected future obligation (ie, if there is a shortfall, contributions will increase and vice versa).

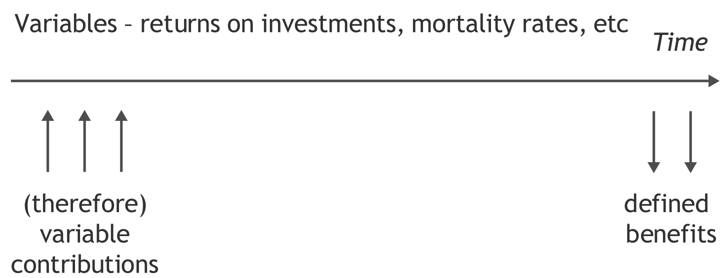


Figure 18.1: Defined benefit plans

Contribution levels

The actuary advises the company on contributions necessary to produce the defined benefits ('the funding plan'). It cannot be certain in advance that contributions plus returns on investments will equal benefits to be paid.

Formal actuarial valuations will be performed periodically (eg, every three years) to reveal any surplus or deficit on the scheme at a given date. Contributions may be varied as a result; for example, the actuary may recommend a contribution holiday (a period during which no contributions are made) to eliminate a surplus.

Risk associated with defined benefit schemes

As the employer is obliged to make up any shortfall in the plan, it is effectively underwriting the **investment** and **actuarial risk** associated with the plan. Thus in a defined benefit plan, the employer carries both the investment and the actuarial risk.

3.2.1 Types of defined benefit plan

There are two types of defined benefit plan:

(a) **Funded plans**

These plans are set up as separate legal entities and are managed independently, often by trustees. Contributions paid by the employer and employee are paid into the separate legal entity. The assets held within the separate legal entities are effectively ring-fenced for the payments of benefits.

Funded plans, illustrated diagrammatically below, represent the most common arrangement.

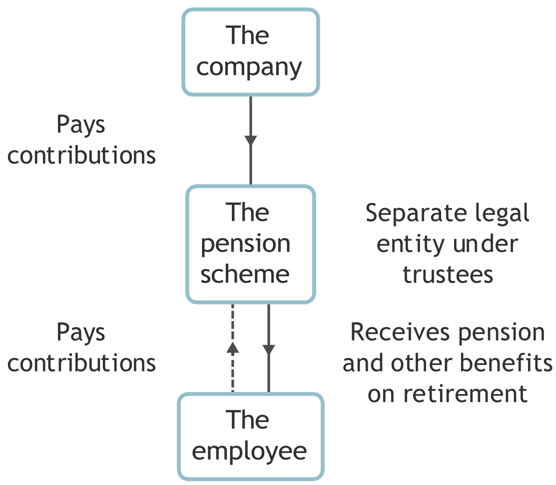


Figure 18.2: Funded plans

(b) **Unfunded plans**

These plans are held within employer legal entities and are managed by the employers' management teams. Assets may be allocated towards the satisfaction of retirement benefit obligations, although these assets are not ring-fenced for the payment of benefits and remain the assets of the employer entity. In the UK and the US, unfunded plans are common in the public sector but rare in the private sector. However, unfunded plans are the normal method of pension provision in many European countries (eg, Germany and France) and also in Japan.

3.2.2 Plans with promised returns on contributions

IAS 19 gives a number of examples of plans that would be deemed to be defined benefit plans even though on the face of it these may appear to be defined contribution. Examples include circumstances where an entity's obligation is not limited to an agreed level of contributions through either a legal or a constructive obligation ie, through an entity's past practices. Examples include:

- where there is a guaranteed level of return on contributions made or on the assets of the plan; in practical terms this means that the employee benefits from the upside potential on the investment but has a level of protection from downside risk;
- where a plan's level of benefits is not linked solely to the amount of contributions made into the plan; or
- where informal practices have led to the entity having a constructive obligation to provide additional benefits under a plan. A past practice of increasing benefits over and above the level due from the plan, to protect the retired person against inflation for example, would create a constructive obligation, even if the entity has no legal requirement to increase benefits.

Context example: Defined contribution or defined benefit?

Scenario 1

Entity ABC has a separately constituted retirement benefit plan for its employees which sets out that both ABC and its employees contribute 7% of annual salaries into the plan; contributions in respect of an individual employee create a right to a specified proportion of the plan assets, which on retirement is then used to buy the employee an annuity.

This is a defined contribution plan, because there appears to be no obligation on the part of ABC, other than to pay its annual 7% contribution.

Scenario 2

Entity DEF has a separately constituted retirement benefit plan for its employees; the plan is the same as the ABC plan, set out above, except that DEF has a contractual obligation to top up the plan assets if the return (calculated according to the rules) on these assets in any year is below 5%.

This is a defined benefit plan, because DEF has provided a guarantee over and above its obligation to make contributions.

Scenario 3

Entity GHI has a separately constituted retirement benefit plan for its employees; the plan is the same as the ABC plan, set out above. For some years GHI has made additional payments directly to retired ex-employees if the increase in the general price index exceeds 7% in any year. Such payments are at the discretion of GHI.

This is a defined benefit plan, because over and above its obligation to make contributions GHI has a past practice of increasing benefits in payment over and above the level due from the plan. This creates a constructive obligation that the entity will continue to do so.

4 Defined contribution plans

Section overview

Accounting for defined contribution plans is straightforward, as the obligation is determined by the amount paid into the plan in each period.

4.1 Recognition and measurement

Contributions into a defined contribution plan by an employer are made in return for services provided by an employee during the period. The employer has no further obligation for the value of the assets of the plan or the benefits payable.

- The entity should recognise contributions payable as an expense in the period in which the employee provides services (except to the extent that labour costs may be included within the cost of assets).
- A liability should be recognised where contributions arise in relation to an employee's service, but remain unpaid at the period end.

  In the unusual situation where contributions are not payable during the period (or within 12 months of the end of the period) in which the employee provides his or her services on which they accrue, the amount recognised should be discounted to reflect the time value of money.
- Any excess contributions paid should be recognised as an asset (prepaid expenses) but only to the extent that the prepayment will lead to a reduction in future payments or a cash refund.

Worked example: Defined contribution plan

Mouse Co agrees to contribute 5% of employees' total remuneration into a post-employment plan each period.

In the year ended 31 December 20X9, the company paid total salaries of £10.5 million. A bonus of £3 million based on the income for the period was paid to the employees in March 20Y0. The company had paid £510,000 into the plan by 31 December 20X9.

Requirement

Calculate the total expense for post-employment benefits for the year and the accrual which will appear in the statement of financial position at 31 December 20X9.

Solution

Total expense

	£
Salaries	10,500,000
Bonus	3,000,000
	13,500,000 × 5% = £675,000

		£	£
DEBIT	Staff costs expenses	675,000	
CREDIT	Cash		510,000
CREDIT	Accruals		165,000

4.2 Disclosure requirements

Where an entity operates a defined contribution plan during the period, it should disclose:

- the amount that has been recognised as an expense during the period in relation to the plan; and
- a description of the plan.

5 Defined benefit plans – recognition and measurement

Section overview

The accounting treatment for defined benefit plans is more complex than that applied to defined contribution plans:

- The value of the pension plan is recognised in the sponsoring employer's statement of financial position.
- Movements in the value of the pension plan are broken down into constituent parts and accounted for separately.

5.1 The problem

As we have seen, contributions to defined benefit schemes will vary depending on whether the actuary assesses the value of the plan to be adequate to meet future obligations.

In some instances there will be a shortfall, in which case the actuary will advise increased contributions. In other instances there may be a surplus, in which case the actuary may recommend a contributions holiday. Contributions will therefore vary substantially from year to year.

For this reason, it is inappropriate to apply the accounting treatment for defined contribution schemes and expense contributions through profit or loss.

5.2 Introduction to accounting for defined benefit plans

IAS 19 instead requires that the defined benefit plan is recognised in the sponsoring entity's statement of financial position as either a liability or asset depending on whether the plan is in deficit or surplus.

The value of the pension plan is calculated in its simplest form as:

	£
Present value of the defined benefit obligation at the reporting date	X
Fair value of plan assets at the reporting date	(X)
Plan deficit/surplus	X/(X)

5.2.1 Present value of the defined benefit obligation

Definition

Defined benefit obligation: The defined benefit obligation is the present value of all expected future payments required to settle the obligation resulting from employee service in the current and prior periods.

Expected future payments

Expected future payments are based on a number of assumptions and estimates, such as:

- the final benefits payable under the plan (often dependent on future salaries, as benefits are often quoted as a percentage of the employee's final salary); and
- the number of members who will draw benefits (this will in turn depend on employee turnover and mortality rates).

Discounting to present value

- Once determined, the expected future benefits should be discounted to present value (including those which may become payable within 12 months) using a discount rate determined by reference to:
  - market yields on high-quality fixed-rate corporate bonds at the reporting date, or where there is no market in such bonds; and
  - market yields on government bonds.

The corporate or government bonds should be denominated in the same currency as the defined benefit obligation, and be for a similar term.

Note: The examples of discount rates used in this chapter are merely to illustrate relevant calculations and may therefore be rather higher than would currently be found in practice.

Performance of valuations

IAS 19 encourages the use of a qualified actuary to measure the defined benefit obligation. However, this is not a requirement.

Frequency of valuations

Valuations are not required at each reporting date; however, they should be carried out sufficiently regularly to ensure that amounts recognised are not materially different from those which would be recognised if they were valued at the reporting date.

5.2.2 Fair value of plan assets

Definition

Plan assets: Those assets held by a long-term benefit fund and those insurance policies which are held by an entity, where the fund/entity is legally separate from the employer and assets/policies can only be used to fund employee benefits.

Investments owned by the employer which have been earmarked for employee benefits but which the employer could use for different purposes are not plan assets.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (IFRS 13).

Guidance on fair value is given in IFRS 13, *Fair Value Measurement*. Under IFRS 13, fair value is a market-based measurement, not an entity-specific measurement. It focuses on assets and liabilities and on exit (selling) prices. It also takes into account market conditions at the measurement date.

IFRS 13 states that valuation techniques must be those which are appropriate and for which sufficient data are available. Entities should maximise the use of relevant **observable inputs** and minimise the use of **unobservable inputs**.

CHAPTER 18

5.3 Actuarial assumptions

Actuarial assumptions are needed **to estimate the size of the future (post-employment) benefits** that will be payable under a defined benefit plan. The main categories of actuarial assumptions are as follows.

(a) **Demographic assumptions** are about mortality rates before and after retirement, the rate of employee turnover, early retirement, claim rates under medical plans for former employees, and so on.

(b) **Financial assumptions** include future salary levels (allowing for seniority and promotion as well as inflation) and the future rate of increase in medical costs (not just inflationary cost rises, but also cost rises specific to medical treatments and to medical treatments required given the expectations of longer average life expectancy).

The standard requires actuarial assumptions to be neither too cautious nor too imprudent: they should be **'unbiased'**. They should also be based on **'market expectations'** at the year end, over the period during which the obligations will be settled.

5.4 Accounting for the movement in defined benefit plans

Both the present value of the defined benefit obligation and the fair value of plan assets, and therefore the overall plan surplus or deficit, will change from year to year. This movement is broken down into its constituent parts and each is accounted for separately.

The opening and closing obligation and plan assets can be reconciled as follows:

	PV of defined benefit obligation	FV of plan assets
	£	£
B/f at start of year (advised by actuary)	(X)	X
Retirement benefits paid out	X	(X)
Contributions paid into plan		X
Interest on plan assets		X

	benefit obligation	FV of plan assets
	£	£
Interest cost on obligation	(X)	
Current service cost	(X)	
	(X)	X
Gains/losses on remeasurement (balancing figure)	X/(X)	X/(X)
C/f at end of year (advised by actuary)	(X)	X

Note that while the interest on plan assets and interest on obligation are calculated separately, they are presented net and the same rate is used for both.

5.5 Outline of the method

There is a **four-step method** for recognising and measuring the expenses and liability of a defined benefit pension plan.

An outline of the method used by an employer to account for the expenses and obligation of a defined benefit plan is given below. The stages will be explained in more detail later.

Step 1

(a) An **actuarial technique** (the **projected unit credit method**) should be used to make a reliable estimate of the amount of future benefits employees have earned from service in relation to the current and prior years. The entity must determine how much benefit should be attributed to service performed by employees in the current period, and in prior periods. Assumptions include, for example, levels of employee turnover, mortality rates and future increases in salaries (if these will affect the eventual size of future benefits such as pension payments).

(b) The benefit should be **discounted** to arrive at the present value of the defined benefit obligation and the current service cost.

(c) The **fair value** of any **plan assets** should be deducted from the present value of the defined benefit obligation.

Step 2 The surplus or deficit measured in Step 1 may have to be adjusted if a net benefit asset has to be restricted by the **asset ceiling** (see section 6.2).

Step 3 Determine the amounts to be recognised in profit or loss:

(a) Current service cost

(b) Any past service cost and gain or loss on settlement

(c) Net interest on the net defined benefit liability (asset)

Step 4 Determine the remeasurements of the net defined benefit liability (asset), to be recognised in other comprehensive income (items that will not be reclassified to profit or loss):

(a) Actuarial gains and losses

(b) Return on plan assets (excluding amounts included in net interest on the net defined benefit liability (asset))

(c) Any change in the effect of the asset ceiling (excluding amounts included in net interest on the net defined benefit liability (asset))

5.5.1 Retirement benefits paid out

During an accounting year, some of the plan assets will be paid out to retirees, thus discharging part of the benefit obligation. This is accounted for by:

DEBIT	PV of defined benefit obligation	X	
CREDIT	FV of plan assets		X

Note that there is no cash entry, as the pension plan itself rather than the sponsoring employer pays the money out.

5.5.2 Contributions paid into plan

Contributions will be made into the plan as advised by the actuary. This is accounted for by:

DEBIT	FV of plan assets	X	
CREDIT	Cash		X

5.5.3 Return on plan assets

Definition

Return on plan assets: Defined as interest, dividends and other revenue derived from plan assets together with realised and unrealised gains or losses on the plan assets, less any costs of administering the plan and less any tax payable by the plan itself.

Accounting for the return on plan assets is explained in more detail below.

5.6 The statement of financial position

In the statement of financial position, the amount recognised as a **defined benefit liability** (which may be a negative amount ie, an asset) should be the following.

(a) The **present value of the defined obligation** at the year end; **minus**

(b) The **fair value of the assets of the plan** as at the year end (if there are any) out of which the future obligations to current and past employees will be directly settled.

The earlier parts of this section have looked at the recognition and measurement of the defined benefit obligation. Now we will look at issues relating to the assets held in the plan.

5.7 Plan assets

Plan assets are:

(a) assets such as stocks and shares, held by a fund that is legally separate from the reporting entity, which exists solely to pay employee benefits; and

(b) insurance policies, issued by an insurer that is not a related party, the proceeds of which can only be used to pay employee benefits.

Investments which may be used for purposes other than to pay employee benefits are not plan assets.

The standard requires that the plan assets are measured at fair value, as 'the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date'. This is consistent with IFRS 13, *Fair Value Measurement*.

IAS 19 includes the following **specific requirements**:

(a) The plan assets should exclude any contributions due from the employer but not yet paid.

(b) Plan assets are reduced by any liabilities of the fund that do not relate to employee benefits, such as trade and other payables.

5.8 The statement of profit or loss and other comprehensive income

All the gains and losses that affect the plan obligation and plan assets must be recognised. The **components of defined benefit cost must be recognised as follows** in the statement of profit or loss and other comprehensive income:

Component	Recognised in
(1) **Service cost**	Profit or loss
(2) **Net interest on the net defined benefit liability**	Profit or loss
(3) **Remeasurements of the net defined benefit liability**	Other comprehensive income (not reclassified to profit or loss)

5.9 Service costs

These comprise the following:

(a) **Current service cost**; this is the increase in the present value of the defined benefit obligation resulting from employee services during the period. The measurement and recognition of this cost was introduced in section 5.5.

(b) **Past service cost**; this is the change in the obligation relating to service in **prior periods**. This results from amendments or curtailments to the pension plan, and

(c) Any **gain or loss on settlement**.

The detail relating to points (b) and (c) above will be covered in a later section. First, we will continue with the basic elements of accounting for defined benefit pension costs.

5.10 Net interest on the net defined benefit liability (asset)

In section 5.5 we looked at the recognition and measurement of the defined benefit obligation. This figure is the discounted **present value** of the future benefits payable. Every year the discount must be 'unwound', increasing the present value of the obligation as time passes through an interest charge.

5.10.1 Interest calculation

IAS 19 requires that the interest should be calculated on the **net defined benefit liability (asset)**. This means that the amount recognised in profit or loss is the net of the interest charge on the obligation and the interest income recognised on the assets.

The **net defined benefit liability/(asset)** should be measured as at the **start** of the accounting period, taking account of changes during the period as a result of contributions paid into the scheme and benefits paid out.

Many exam questions include the assumption that all payments into and out of the scheme take place at the end of the year, so that the interest calculations can be based on the opening balances.

5.10.2 Discount rate

The **discount rate** adopted should be determined by reference to **market yields on high-quality fixed-rate corporate bonds**. In the absence of a 'deep' market in such bonds, the yields on comparable government bonds should be used as reference instead. The maturity of the corporate bonds that are used to determine a discount rate should have a term to maturity that is consistent with the expected maturity of the post-employment benefit obligations, although a single weighted average discount rate is sufficient.

Professional skills focus: Structuring problems and solutions

While the discount rate will generally be given to you in the exam, in practice it changes, and this can have an impact on the net present value. In the July 2021 exam candidates were asked to consider how a change in discount rate for a pension liability would affect the net present value. Excel file can be used to try out different discount rates and see their effect on the NPV.

Worked example: Interest cost

In 20X8, an employee leaves a company after working there for 24 years. The employee chooses to leave their accrued benefits in the pension scheme until they retire in seven years' time (they now work for another company).

At the time of their departure, the actuary calculates that it is necessary at that date to have a fund of
£296,000 to pay the expected pensions to the ex-employee when they retire.

At the start of the year, the yield on high quality corporate debt was 8%, and remained the same throughout the year and the following year.

Requirement

Calculate the interest cost to be debited to profit or loss in Years 1 and 2.

Solution

Interest cost to be debited to profit or loss

	£
Year 1:	
Discounted cost b/f	296,000
Interest cost (profit or loss) (8% × £296,000)	23,680
Obligation c/f (statement of financial position)	319,680
Year 2:	
Interest cost (profit or loss) (8% × £319,680)	25,574
Obligation c/f (statement of financial position)	345,254

5.11 Remeasurements of the net defined benefit liability

Remeasurements of the net defined benefit liability/(asset) comprise the following:

(a) Actuarial gains and losses

(b) The return on plan assets (excluding amounts included in net interest on the net defined benefit liability/(asset))

(c) Any change in the effect of the asset ceiling (excluding amounts included in net interest on the net defined benefit liability/(asset))

The gains and losses relating to points (a) and (b) above will arise in every defined benefit scheme so we will look at these in this section. The asset ceiling is a complication that is not relevant in every case, so it is dealt with separately, later in the chapter.

5.11.1 Actuarial gains and losses

Actuarial gains and losses arise for several reasons, and IAS 19 requires these to be recognised in full in other comprehensive income.

At the end of each accounting period, a new valuation, using updated assumptions, should be carried out on the obligation. Actuarial gains or losses arise because of the following.

- Actual events (eg, employee turnover, salary increases) differ from the actuarial assumptions that were made to estimate the defined benefit obligations
- The effect of changes to assumptions concerning benefit payment options
- Estimates are revised (eg, different assumptions are made about future employee turnover, salary rises, mortality rates, and so on)
- The effect of changes to the discount rate

Actuarial gains and losses are recognised in **other comprehensive income**. They are **not reclassified to profit or loss** under the 2011 revision to IAS 1 (see Chapter 9).

5.11.2 Return on plan assets

The return on plan assets must be calculated.

A new valuation of the plan assets is carried out at each period end, using current fair values. Any difference between the new value, and what has been recognised up to that date (normally the opening balance, interest, and any cash payments into or out of the plan) is treated as a 'remeasurement' and recognised in other comprehensive income.

Note: In the examples in this chapter, it is assumed that cash from contributions is received and pensions paid out at the end of the year, as no interest arises on it. In practice, it is more likely that contributions would be paid in part way through the year, and pensions paid out part way through the year or evenly over the year.

Worked example: Remeasurement of the net defined benefit liability

At 1 January 20X2 the fair value of the assets of a defined benefit plan was £1,100,000 and the present value of the defined benefit obligation was £1,250,000. On 31 December 20X2, the plan received contributions from the employer of £490,000 and paid out benefits of £190,000.

The current service cost for the year was £360,000 and a discount rate of 6% is to be applied to the net liability/(asset).

After these transactions, the fair value of the plan's assets at 31 December 20X2 was £1.5 million. The present value of the defined benefit obligation was £1,553,600.

Requirement

Calculate the gains or losses on remeasurement through other comprehensive income (OCI) and the return on plan assets and illustrate how this pension plan will be treated in the statement of profit or loss and other comprehensive income and statement of financial position for the year ended 31 December 20X2.

Solution

It is always useful to set up a working reconciling the assets and obligation:

	Assets	Obligation
	£	£
Fair value/present value at 1.1.X2	1,100,000	1,250,000
Interest (1,100,000 × 6%)/(1,250,000 × 6%)	66,000	75,000
Current service cost		360,000
Contributions received	490,000	
Benefits paid	(190,000)	(190,000)
Return on plan assets excluding amounts in net interest (balancing figure) (OCI)	34,000	–
Loss on remeasurement (balancing figure) (OCI)		58,600
	1,500,000	1,553,600

The following accounting treatment is required.

(1) In the **statement of profit or loss and other comprehensive income**, the following amounts will be recognised.

	£
In **profit or loss**:	
Current service cost	360,000
Net interest on net defined benefit liability (75,000 – 66,000)	9,000
In **other comprehensive income** (34,000 – 58,600)	24,600

(2) In the **statement of financial position**, the net defined benefit liability of £53,600 (1,553,600 – 1,500,000) will be recognised.

5.12 Section summary

The recognition and measurement of defined benefit plan costs are complex issues.

- Learn and understand the definitions of the various elements of a defined benefit pension plan
- Learn the outline of the method of accounting (see section 5.5)
- Learn the recognition method for the:
  - statement of financial position
  - statement of profit or loss and other comprehensive income

6 Defined benefit plans – other matters

Section overview

We have now covered the basics of accounting for defined benefit plans. This section looks at the special circumstances of:

- past service costs
- curtailments
- settlements
- asset ceiling test

6.1 Past service cost and gains and losses on settlement

In section 5.9 we identified that the total service cost may comprise not only the current service cost but also other items, past service cost and gains and losses on settlement. This section explains these issues and their accounting treatment.

6.1.1 Past service cost

Past service cost is the change in the present value of the defined benefit obligation resulting from a plan **amendment** or **curtailment**.

A plan **amendment** arises when an entity either introduces a defined benefit plan or **changes the benefits payable** under an existing plan. As a result, the entity has taken on additional obligations that it has not hitherto provided for. For example, an employer might decide to introduce a medical benefits scheme for former employees. This will create a new defined benefit obligation that has not yet been provided for.

A **curtailment occurs when an entity significantly reduces the number of employees covered by a plan**. This could result from an isolated event, such as closing a plant, discontinuing an operation or the termination or suspension of a plan.

Past service costs can be either **positive** (if the changes increase the obligation) or **negative** (if the change reduces the obligation).

6.1.2 Gains and losses on settlement

A **settlement** occurs when an employer enters into a transaction to eliminate part or all of its post- employment benefit obligations (other than a payment of benefits to or on behalf of employees under the terms of the plan and included in the actuarial assumptions).

A curtailment and settlement might **happen together**, for example when an employer brings a defined benefit plan to an end by settling the obligation with a one-off lump-sum payment and then scrapping the plan.

The gain or loss on a settlement is the difference between:

(a) the **present value of the defined benefit obligation** being settled, as valued on the date of the settlement; and

(b) the **settlement price**, including any plan assets transferred and any payments made by the entity directly in connection with the settlement.

6.1.3 Accounting for past service cost and gains and losses on settlement

An entity should **remeasure the obligation** (and the related plan assets, if any) using current actuarial assumptions, before determining past service cost or a gain or loss on settlement.

The rules for recognition for these items are as follows.

Past service costs are recognised at the earlier of the following dates:

(a) When the plan amendment or curtailment occurs

(b) When the entity recognises related restructuring costs (in accordance with IAS 37) or termination benefits

All gains and losses arising from past service costs or settlements must be recognised immediately in profit or loss.

6.2 Asset ceiling test

When we looked at the recognition of the net defined benefit liability/(asset) in the statement of financial position at the beginning of section 5 the term 'asset ceiling' was mentioned. This term relates to a threshold established by IAS 19 to ensure that any defined benefit asset (ie, a pension surplus) is carried at **no more than its recoverable amount**. In simple terms, this means that any net asset is restricted to the amount of cash savings that will be available to the entity in future.

6.3 Net defined benefit assets

A net defined benefit asset may arise if the plan has been overfunded or if actuarial gains have arisen. This meets the definition of an asset (as stated in the *Conceptual Framework*) because **all** the following apply.

(a) The entity **controls a resource** (the ability to use the surplus to generate future benefits).

(b) That control is the **result of past events** (contributions paid by the entity and service rendered by the employee).

(c) **Future benefits** are available to the entity in the form of a reduction in future contributions or a cash refund, either directly or indirectly to another plan in deficit.

The **asset ceiling** is the **present value** of those future benefits. The **discount rate used is the same** as that used to calculate the net interest on the net defined benefit liability/(asset). The net defined benefit asset would be reduced to the asset ceiling threshold. Any related write-down would be treated as a **remeasurement** and recognised in **other comprehensive income**.

If the asset ceiling adjustment was needed in a subsequent year, the changes in its value would be treated as follows:

(a) **Interest** (as it is a discounted amount) recognised in profit or loss as part of the net interest amount

(b) **Other changes** recognised in profit or loss

6.4 Other issues

6.4.1 Multiple plans and offsetting

Where a sponsoring employer runs more than one defined benefit scheme, each must be accounted for separately and a plan deficit in one cannot be set off against a plan surplus in another unless there is a legal right of offset and the entity intends to settle on a net basis.

6.4.2 Projected unit credit method

The projected unit credit method is the method required by IAS 19 to be used in determining the present value of the defined benefit obligation and current service cost.

This method sees each period of service giving rise to an additional unit of benefit entitlement (ie, for each extra year worked by an employee, their pension increases).

Each of these units is measured separately and the total of all units to date (both current year and previous years) is the final obligation under the plan.

The total of the current year units is the current service cost.

Attribution of benefit to period of service

In order to apply the projected unit credit method, a unit, or amount of future benefit, must be attributed to each period of service.

Worked example: Projected unit credit method 1

A defined benefit plan provides a lump-sum benefit of £100 per year of service payable on retirement.

Requirement

How is this benefit attributed to periods of service and how is the resulting current service cost and defined benefit obligation calculated?

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Solution

A benefit of £100 is attributed to each year.

The current service cost = the present value of £100.

The present value of the defined benefit obligation = the present value of £100 × number of years of service to reporting date.

Worked example: Projected unit credit method 2

A company operates a defined benefit scheme that pays a lump-sum benefit equal to £500 for each year of service.

An employee joins the company at the beginning of Year 1 and is due to retire after five years of service.

For the sake of simplicity ignore the possibility of the employee leaving the company before the expected date.

The discount rate is 10%.

Requirement

Calculate the current service cost to be debited to profit or loss in Years 1 to 5, and the present value of the defined benefit obligation in each of these years.

Solution

Current service cost to be debited to profit or loss

Year	**1**	**2**	**3**	**4**	**5**
	£	**£**	**£**	**£**	**£**
Current year benefit	500	500	500	500	500
Current service cost	500 ÷ (1.1)4	500 ÷ (1.1)3	500 ÷ (1.1)2	500 ÷ (1.1)	
	= 342	= 376	= 413	= 455	500
PV of defined benefit obligation	342	376 × 2	413 × 3	455 × 4	500 × 5
		= 752	= 1,239	= 1,820	= 2,500

Note: Previously we have said that the present value of the obligation moves from year to year due to: payments out to retirees, the unwinding of one year's discount, and the current service cost.

This can be applied to Year 2 as follows:

	£
PV of defined benefit obligation b/f	342
Unwinding of discount (342 × 10%)	34
Current service cost	376
PV of defined benefit obligation c/f	752

6.5 Suggested approach

The suggested approach to defined benefit schemes is to deal with the change in the obligation and asset in the following order.

Step	Item	Recognition
1	**Record opening figures:** Asset Obligation	
2	**Interest cost on obligation** Based on discount rate and PV obligation at start of period. Should also reflect any changes in obligation during period.	DEBIT – Interest cost (P/L) (x% × b/d obligation) CREDIT – PV defined benefit obligation (SOFP)
3	**Interest on plan assets** Based on discount rate and asset value at start of period. Technically, this interest is also time apportioned on contributions less benefits paid in the period.	DEBIT – Plan assets (SOFP) CREDIT – Interest cost (P/L) (x% × b/d assets)
4	**Current service cost** Increase in the present value of the obligation resulting from employee service in the current period.	DEBIT – Current service cost (P/L) CREDIT– PV defined benefit obligation (SOFP)
5	**Contributions** As advised by actuary.	DEBIT – Plan assets (SOFP) CREDIT – Company cash
6	**Benefits** Actual pension payments made.	DEBIT – PV defined benefit obligation (SOFP) CREDIT – Plan assets (SOFP)
7	**Past service cost** Increase/decrease in PV obligation as a result of introduction or improvement of benefits.	**Positive (increase in obligation):** DEBIT – Past service cost (P/L) CREDIT – PV defined benefit obligation (SOFP) **Negative (decrease in obligation):** DEBIT – PV defined benefit obligation (SOFP) CREDIT – Past service cost (P/L)

Step	Item	Recognition
8	**Gains and losses on settlement** Difference between the value of the obligation being settled and the settlement price.	**Gain** DEBIT – PV defined benefit obligation (SOFP) CREDIT – Service cost (P/L) **Loss** DEBIT – Service cost (P/L) CREDIT – PV defined benefit obligation (SOFP)
9	**Remeasurements: actuarial gains and losses** Arising from annual valuations of obligation. On obligation, differences between actuarial assumptions and actual experience during the period, or changes in actuarial assumptions.	**Gain** DEBIT – PV defined benefit obligation (SOFP) CREDIT – Other comprehensive income **Loss** DEBIT – Other comprehensive income CREDIT – PV defined benefit obligation (SOFP)
10	**Remeasurements: return on assets (excluding amounts in net interest)** Arising from annual valuations of plan assets	**Gain** DEBIT – FV plan assets (SOFP) CREDIT – Other comprehensive income **Loss** DEBIT – Other comprehensive income CREDIT – FV plan assets (SOFP)
11	**Disclose in accordance with the standard**	See section 7.

Professional skills focus: Structuring problems and solutions

The good news is that exam pension questions usually give rise to the structured approach suggested in the above table. However, the question is unlikely to have all the elements in the table, for example, a settlement.

Interactive question 1: Defined benefit plan 1

For the sake of simplicity and clarity, all transactions are assumed to occur at the year end.

The following data applies to the post-employment defined benefit compensation scheme of BCD Co.

Discount rate: 10% (each year)

Present value of obligation at start of 20X2: £1m Market value of plan assets at start of 20X2: £1m The following figures are relevant.

	20X2	20X3	20X4
	£'000	£'000	£'000
Current service cost	140	150	150
Benefits paid out	120	140	150
Contributions paid by entity	110	120	120
Present value of obligation at year end	1,200	1,650	1,700
Fair value of plan assets at year end	1,250	1,450	1,610

Additional information:

(1) At the end of 20X3, a division of the company was sold. As a result of this, a number of the employees of that division opted to transfer their accumulated pension entitlement to their new employer's plan. Assets with a fair value of £48,000 were transferred to the other company's plan and the actuary has calculated that the reduction in BCD's defined benefit liability is £50,000. The year-end valuations in the table above were carried out **before** this transfer was recorded.

(2) At the end of 20X4, a decision was taken to make a one-off additional payment to former employees currently receiving pensions from the plan. This was announced to the former employees before the year end. This payment was not allowed for in the original terms of the scheme. The actuarial valuation of the obligation in the table above **includes** the additional liability of £40,000 relating to this additional payment.

Requirement

Show how the reporting entity should account for this defined benefit plan in each of years 20X2, 20X3 and 20X4.

See **Answer** at the end of this chapter.

Interactive question 2: Defined benefit plan 2

Peters operates a defined benefit pension plan for its employees. At 1 January 20X5 the fair value of the pension plan assets was £5,200,000 and the present value of the plan liabilities was £5,800,000.

The actuary estimates that the current and past service costs for the year ended 31 December 20X5 are £900,000 and £180,000 respectively. The past service cost is caused by an increase in pension benefits. The plan liabilities at 1 January and 31 December 20X5 correctly reflect the impact of this increase.

The yield on high-quality corporate bonds is estimated at 8% and the expected return on plan assets at 5%.

The pension plan paid £480,000 to retired members in the year to 31 December 20X5. Peters paid £1,460,000 in contributions to the pension plan and this included £180,000 in respect of past service costs.

At 31 December 20X5 the fair value of the pension plan assets is £6,800,000 and the present value of the plan liabilities is £7,000,000.

In accordance with IAS 19, *Employee Benefits,* Peters recognises gains and losses on remeasurement of the defined benefit asset/liability in other comprehensive income in the period in which they occur.

Requirement

Calculate the actuarial gains or losses on pension plan assets and liabilities that will be included in other comprehensive income for the year ended 31 December 20X5. (Round all figures to the nearest £'000.)

See **Answer** at the end of this chapter.

Interactive question 3: Defined benefit plan 3

The defined benefit pension plan of Leadworth plc was formed on 1 January 20X3. The following details relate to the scheme at 31 December 20X3.

	£m
Present value of obligation	208
Fair value of plan assets	200
Current service cost for the year	176
Contributions paid	160
Interest cost on obligation for the year	32
Interest on plan assets for the year	16

The directors are aware that IAS 19 has been revised but are unsure how to treat any gain or loss on remeasurement of the plan asset or liability.

Requirement

Show how the defined benefit pension plan should be dealt with in the financial statements for the year ended 31 December 20X3.

See **Answer** at the end of this chapter.

Interactive question 4: Defined benefit plan 4

Baseline plc has a defined benefit pension scheme and wishes to recognise the full deficit in its statement of financial position.

Requirement

Using the information below, prepare extracts from the statement of financial position and the statement of comprehensive income, together with a reconciliation of scheme movements for the year ended 31 January 20X8. Ignore taxation.

(1) The opening scheme assets were £3.6 million on 1 February 20X7 and scheme liabilities at this date were £4.3 million.

(2) Company contributions to the scheme during the year amounted to £550,000.

(3) Pensions paid to former employees amounted to £330,000 in the year.

(4) The yield on high-quality corporate bonds was 8% and the actual return on plan assets was £295,000.

(5) During the year, five staff were made redundant, and an extra £58,000 in total was added to the value of their pensions.

(6) Current service costs as provided by the actuary are £275,000.

(7) The actuary valued the plan liabilities at 31 January 20X8 as £4.54 million.

See **Answer** at the end of this chapter.

Professional skills focus: Assimilating and using information

As you will have seen in the above interactive questions, all the information given in the pensions element of a question is used in the answer. Assimilating it and using it is therefore the straightforward bit, at least in the exam. In practice, this may be much harder.

7 Defined benefit plans – disclosure

Section overview

- The disclosure requirements for defined benefit plans are extensive and detailed in order to enable users to understand the plan and the nature and extent of the entity's commitment.

Detailed disclosure requirements are set out in IAS 19 in relation to defined benefit plans, to provide users of the financial statements with information that enables an evaluation of the nature of the plan and the financial effect of any changes in the plan during the period.

Requirements for disclosures include a description of the plan, a reconciliation of the fair value of plan assets from the opening to closing position, the actual return on plan assets, a reconciliation of movements in the present value of the defined benefit obligation during the period, an analysis of the total expense recognised in profit or loss, and the principal actuarial assumptions made.

Additional disclosures set out in the amendment to IAS 19 include:

- an analysis of the defined benefit obligation between amounts relating to unfunded and funded plans;
- a reconciliation of the present value of the defined benefit obligation between the opening and closing statement of financial position, separately identifying each component in the reconciliation;
- a reconciliation of the present value of the defined benefit obligation and the fair value of the plan assets to the pension asset or liability recognised in the statement of financial position;
- a breakdown of plan assets for the entity's own financial instruments, for example an equity interest in the employing entity held by the pension plan and any property occupied by the entity or other assets used by the entity;
- for each major category of plan assets the percentage or amount that it represents of the total fair value of plan assets;
- the effect of a one percentage point increase or decrease in the assumed medical cost trend rate on amounts recognised during the period, such as service cost and the pension obligation relating to medical costs;

- amounts for the current annual period and the previous four annual periods of the present value of the defined benefit obligation, fair value of plan assets and the resulting pension surplus or deficit, and experience adjustments on the plan liabilities and assets in percentage or value terms; and
- an estimate of the level of future contributions to be made in the following reporting period.

8 Other long-term employee benefits

Section overview

The accounting treatment for other long-term employee benefits is a simplified version of that adopted for defined benefit plans.

Definition

Other long-term employee benefits: Employee benefits (other than post-retirement benefit plans and termination benefits) which do not fall due wholly within 12 months after the end of the period in which the employees render the service.

Examples of other long-term employee benefits include **long-term disability benefits** and **paid sabbatical leave**.

Although such long-term benefits have many of the attributes of a defined benefit pension plan, they are not subject to the same level of uncertainty. Furthermore, the introduction of such benefits or changes to these benefits rarely causes a material amount of past service cost. As a consequence, the accounting treatment adopted is a simplified version of that for a defined benefit plan. The only difference is that all actuarial gains and losses are recognised immediately in profit or loss.

9 Termination benefits

Section overview

Termination benefits are recognised as an expense when the entity is committed to either:

- terminating the employment before normal retirement date; or
- providing termination benefits in order to encourage voluntary redundancy.

Definition

Termination benefits: Employee benefits payable on the termination of employment, through voluntary redundancy or as a result of a decision made by the employer to terminate employment before the normal retirement date.

Where voluntary redundancy has been offered, the entity should measure the benefits based on an expected level of take-up. If, however, there is uncertainty about the number of employees who will accept the offer, then there may be a contingent liability, requiring disclosure under IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

An entity should recognise a termination benefit when it has made a firm commitment to end the employment. Such a commitment will exist where, for example, the entity has a detailed formal plan for the termination and it cannot realistically withdraw from that commitment.

Where termination benefits fall due more than 12 months after the reporting date they should be discounted.

Worked example: Termination benefits

The directors of an entity met on 23 July 20X3 to discuss the need to decrease costs by reducing the number of employees. On 17 August 20X3 they met again to agree a plan. On 6 September 20X3 other members of the management team were informed of the plan. On 7 October 20X3 the plan was announced to the employees affected and implementation of the formalised plan began.

Requirement

When should the entity recognise the liability?

Solution

The entity should only recognise the liability for the termination benefits when it is demonstrably committed to terminating the employment of those affected. This occurred on 7 October 20X3 when the formal plan was announced and it is at this date that there is no realistic chance of withdrawal.

10 IAS 26, *Accounting and Reporting by Retirement Benefit Plans*

Section overview

IAS 26 applies to the preparation of financial reports by retirement benefit plans which are either set up as separate entities and run by trustees or held within the employing entity.

10.1 Objectives, scope and definitions of IAS 26

The objective of IAS 26 is to provide useful and consistently produced information on retirement benefit plans for members of the plans and other interested parties.

IAS 26 should be applied in the preparation of financial reports by retirement benefit plans.

Although it is commonplace for a retirement benefit plan to be set up as a separate legal entity run by independent trustees, plan assets may be held within the entity employing the plan's members. IAS 26 applies in both sets of circumstances. In the latter case IAS 26 still regards the retirement benefit plan as a reporting entity separate from the employing entity.

The preparation of a retirement benefit plan's financial report should be in accordance with not only IAS 26 but also all other international standards to the extent that they are not overridden by IAS 26.

IAS 26 does not cover:

- the preparation of reports to individual participants about their retirement benefit rights; or
- the determination of the cost of retirement benefits in the financial statements of the employer having pension plans for its employees and providing other employee benefits.

Definition

Retirement benefit plans: Arrangements whereby an entity provides benefits for its employees on or after termination of service (either in the form of an annual income or as a lump sum), when such benefits, or the employer's contributions towards them, can be determined or estimated in advance of retirement from the provisions of a document or from the entity's practices.

There are two main types of retirement benefit plan, both discussed in section 3 of this chapter.

(a) **Defined contribution plans** (sometimes called 'money purchase schemes'). These are retirement plans under which payments into the plan are fixed. Subsequent payments out of the plan to retired members will therefore be determined by the value of the investments made from the contributions that have been made into the plan and the investment returns reinvested.

(b) **Defined benefit plans** (sometimes called 'final salary schemes'). These are retirement plans under which the amount that a retired member will receive from the plan during retirement is fixed. Contributions are paid into the scheme based on an estimate of what will have to be paid out under the plan.

Interactive question 5: Scope

To which of the following does IAS 26, *Accounting and Reporting by Retirement Benefit Plans* apply?

A The general purpose financial reports of pension schemes

B The cost to companies of employee retirement benefits

C The financial statements relating to an actuarial business

D Reports to individuals of their future retirement benefits

See **Answer** at the end of this chapter.

10.2 Key concepts

'**Funding**' represents the employer's contributions paid to the fund in order to meet the future obligations under the plan for the payment of retirement benefits.

'**Participants**' are those employees who will benefit under the plan (ie, employees and retired employees).

The '**net assets available for benefits**' are the assets less liabilities of the plan that are available to generate future investment income that will increase the plan's assets. These net assets are calculated before the deduction of the actuarial assessment of promised retirement benefits.

10.3 Key requirements

The following summarises the key requirements of IAS 26.

Key requirements	Defined contribution plans	Defined benefit plans	All retirement plans
Investments to be carried at fair value wherever possible			Yes
Recognition of the actuarial present value of promised retirement benefits		Yes	
A statement of changes in net assets available for benefits			Yes
No requirement for an actuarial report	Yes		

10.4 Disclosure

The report of all retirement benefit plans should include the following information.

- A statement of changes in the net assets that are available in the fund to provide future benefits
- A summary of the plan's significant accounting policies

The statement of changes in the net assets available to provide future benefits should disclose a full reconciliation showing movements during the period, for example contributions made to the plan split between employee and employer, investment income, expenses and benefits paid out.

Information should be provided on the plan's funding policy, the basis of valuation for the assets in the fund and details of significant investments that exceed a 5% threshold of net assets in the fund available for benefits. Any liabilities that the plan has other than those of the actuarially calculated figure for future benefits payable and details of any investment in the employing entity should also be disclosed.

General information should be included about the plan, such as the names of the employing entities, the groups of employees that are members of the plan, the number of participants receiving benefits under the plan and the nature of the plan i.e., defined contribution or defined benefit. If employees contribute to the plan, this should be disclosed along with an explanation of how the promised benefits are calculated and details of any termination terms of the plan. If there have been changes in any of the information disclosed then this fact should be explained.

Professional skills focus: Concluding, recommending and communicating

Users of IAS 26 reports include plan members, who do not usually have specialist knowledge. The general information referred to above should therefore be clearly written, avoiding special jargon.

11 Audit focus

Section overview

- The estimation of pension costs, particularly those for defined benefit pension schemes, involves a high level of uncertainty.
- The auditor must evaluate the appropriateness of the fair value measurements.

Fair value accounting applies to pension costs, so auditors must be aware of the issues around auditing fair value when auditing this area. Please refer back to earlier chapters for further details on the IAASB's guidance on auditing fair value.

Context example: British Home Stores (BHS)

Established UK high street retailer BHS went into administration in 2016, ceasing to trade later in the same year. It had been sold by its previous owner Arcadia to Retail Acquisitions Ltd in 2015 for £1 in the hope that the company's underlying trading position could be improved. However, in addition to this problem, BHS had also been attempting to improve its pension scheme which was displaying significant deficits: by 2016, the funding level of the scheme was as low as 65% showing a combined deficit that was valued as high as £571 million. In 2017, the 19,000 members received news of a settlement worth £363 million from Sir Philip Green, the previous owner, who had agreed to address the deficit. In 2018, the remaining liabilities of the fund were sold to an insurance company.

While most of the blame associated with the demise of BHS has been attributed to both Philip Green and the person to whom he sold BHS, Dominic Chappell, and their combined failure to address the problems faced by BHS, the importance of the pension scheme cannot be overestimated, given the sums required to address its liabilities and the impact they would have had on its already strained financial position.

(Source: The Pensions Regulator (2017) *TPR publishes report on BHS case.* [Online]. Available from: www.thepensionsregulator.gov.uk/en/media-hub/press-releases/tpr-publishes-report-on-bhs-case [Accessed 3 October 2019]

Auditors need to ensure they have reviewed the various assumptions used by management when accounting for pension schemes and have assessed their sensitivity to change in the current economic climate using suitable levels of professional scepticism. The issues discussed in auditing chapters on ISA 540 (Revised) are extremely relevant here: **complexity**, **subjectivity** and **estimation uncertainty**.

11.1 Auditing pension costs

The table below summarises the areas of audit focus, and the audit evidence required, when auditing pension costs.

Issue	Evidence
Scheme assets (including quoted and unquoted securities, debt instruments, properties)	• Ask directors to reconcile the scheme assets valuation at the scheme year-end date with the assets valuation at the reporting entity's date being used for IAS 19 purposes. • Obtain direct confirmation of the scheme assets from the investment custodian. • Consider requiring scheme auditors to perform procedures.

Issue	Evidence
Scheme liabilities	• Auditors must follow the principles relating to work done by a management's expert as defined in ISA (UK) 500, *Audit Evidence* (and covered in Chapter 6) to assess whether it is appropriate to rely on the actuary's work. • Specific matters would include: - the source data used; - the assumptions and methods used; and - the results of actuaries' work in the light of auditors' knowledge of the business and results of other audit procedures. • Actuarial source data is likely to include: - scheme member data (for example, classes of member and contribution details); and - scheme asset information (for example, values and income and expenditure items).
Actuarial assumptions (for example, mortality rates, termination rates, retirement age and changes in salary and benefit levels)	Auditors will not have the same expertise as actuaries and are unlikely to be able to challenge the appropriateness and reasonableness of the assumptions. They should nevertheless ascertain the qualifications and experience of the actuaries. Auditors can, also, through discussion with directors and actuaries: • obtain a general understanding of the assumptions and review the process used to develop them; • consider whether assumptions comply with IAS 19 requirements ie, are unbiased and based on market expectations at the year end, over the period during which obligations will be settled; • compare the assumptions with those which directors have used in prior years; • consider whether, based on their knowledge of the reporting entity and the scheme, and on the results of other audit procedures, the assumptions appear to be reasonable and compatible with those used elsewhere in the preparation of the entity's financial statements; and • obtain **written representations** from directors confirming that the assumptions are consistent with their knowledge of the business.
Items charged to profit or loss (current service cost, past service cost, gains and losses on settlements and	• Discuss with directors and actuaries the factors affecting current service cost (for example, a scheme closed to new entrants may see an increase year on year as a percentage of pay with the average age of the workforce increasing).
curtailments)	• Confirm that net interest cost has been based on the discount rate determined by reference to market yields on high-quality fixed-rate corporate bonds.

CHAPTER 18

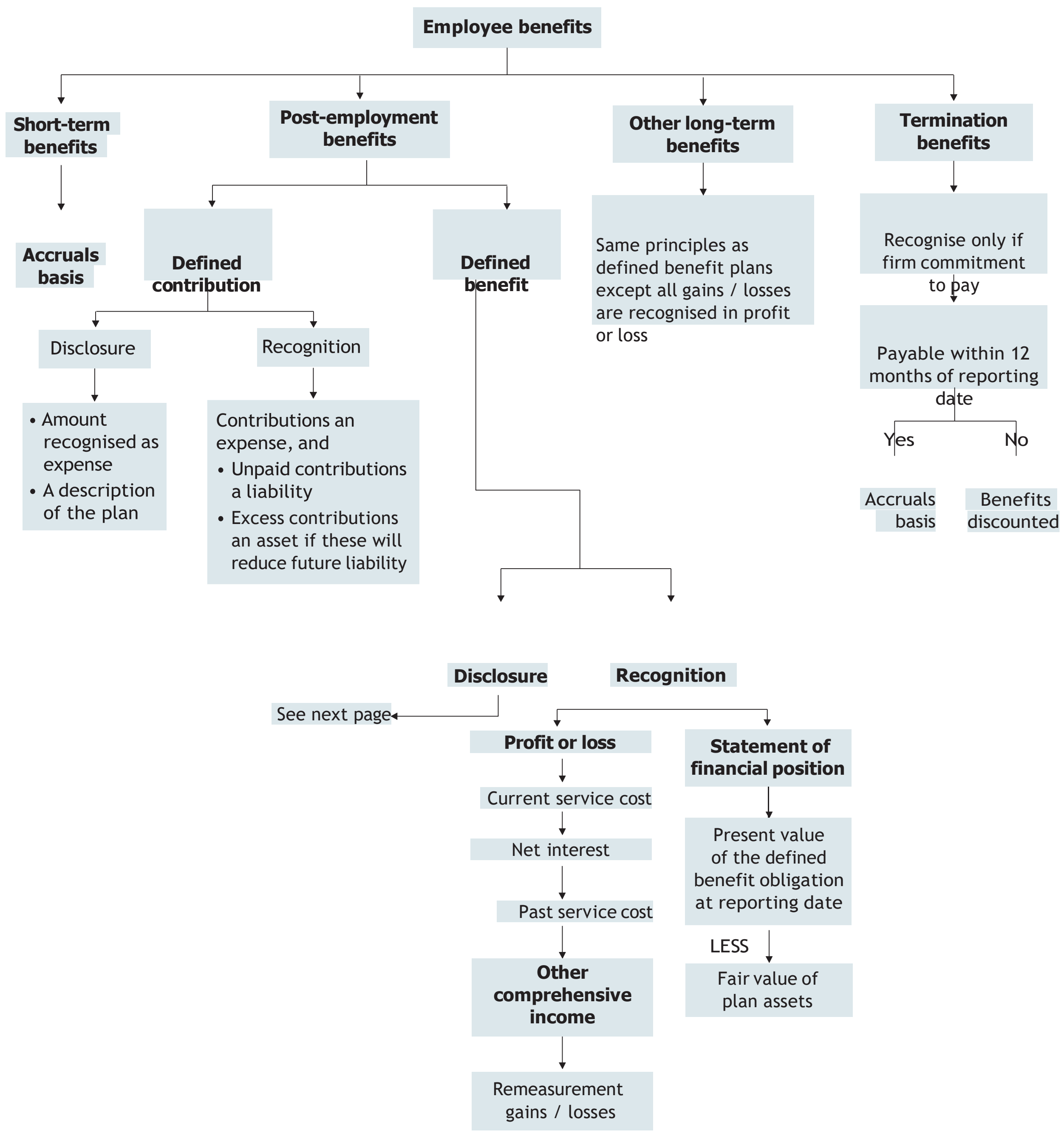
Issue	Evidence
Items recognised in other comprehensive income	• Check basis of updated assumptions used to calculate actuarial gains/losses. • Check basis of calculation of return on plan assets ie, using current fair values. Fair values must be measured in accordance with IFRS 13.
Contributions paid into plan (Retirement benefits paid out are paid by the pension plan itself so there is no cash entry in the entity's books)	Agree cash payments to cash book/bank statements.

Where the results of auditors' work are inconsistent with those reached by directors and actuaries, additional procedures, such as requesting directors to obtain evidence from another actuary, may help in resolving the inconsistency.

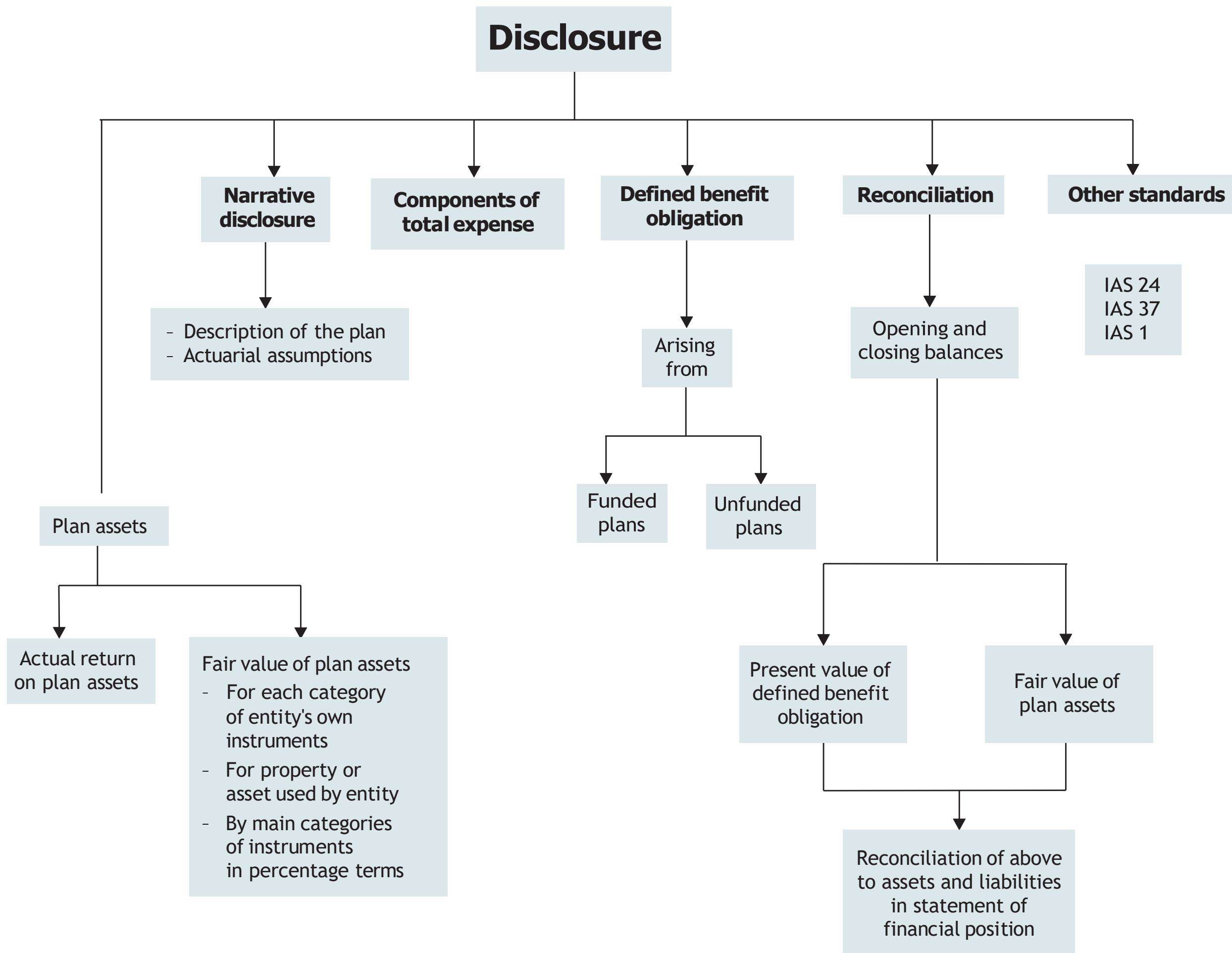
Professional skills focus: Concluding, recommending and communicating

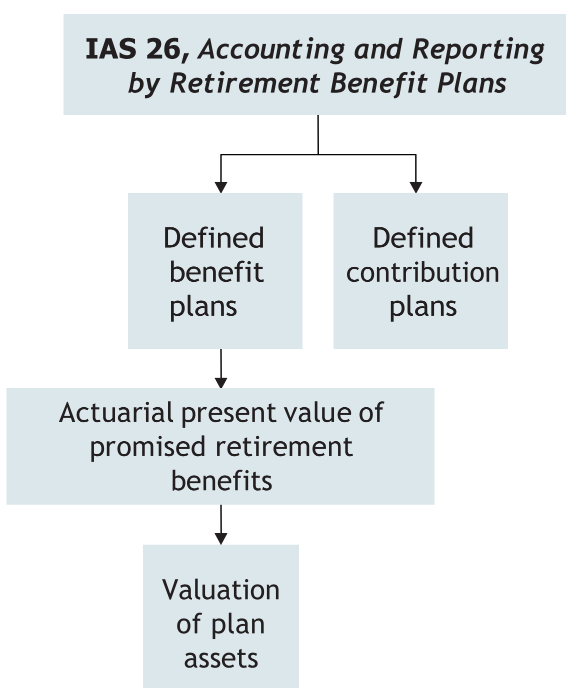
Employee benefits, particularly retirement benefits, are a sensitive area of any audit given the widely publicised, if rare, scandals regarding appropriation. Communication skills are of paramount importance for the auditor.

Summary



Employee benefits
Short-term benefits
Post-employment benefits
Other long-term benefits
Termination benefits
Accruals basis
Defined contribution
Defined benefit
Same principles as defined benefit plans except all gains / losses are recognised in profit or loss
Recognise only if firm commitment to pay
Payable within 12 months of reporting date
Yes
No
Accruals basis
Benefits discounted
Disclosure
Recognition
• Amount recognised as expense
• A description of the plan
Contributions an expense, and
• Unpaid contributions a liability
• Excess contributions an asset if these will reduce future liability
Disclosure
Recognition
See next page
Profit or loss
Statement of financial position
Current service cost
Net interest
Past service cost
Other comprehensive income
Remeasurement gains / losses
Present value of the defined benefit obligation at reporting date
LESS
Fair value of plan assets


Disclosure
Narrative disclosure
Components of total expense
Defined benefit obligation
Reconciliation
Other standards
- Description of the plan
- Actuarial assumptions
Arising from
Opening and closing balances
IAS 24
IAS 37
IAS 1
Funded plans
Unfunded plans
Plan assets
Actual return on plan assets
Fair value of plan assets
- For each category of entity's own instruments
- For property or asset used by entity
- By main categories of instruments in percentage terms
Present value of defined benefit obligation
Fair value of plan assets
Reconciliation of above to assets and liabilities in statement of financial position


IAS 26, Accounting and Reporting by Retirement Benefit Plans
Defined benefit plans
Defined contribution plans
Actuarial present value of promised retirement benefits
Valuation of plan assets

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	What is the IAS 19 accounting treatment for holiday pay? (Topic 2)
2.	Can you distinguish a defined contribution pension plan from a defined benefit plan? (Topic 3)
3.	How is the value of a defined benefit pension plan calculated? (Topic 3)
4.	Can you account for the movement in a defined benefit plan? (Topic 4)
5.	What is the IAS 19 treatment of gains and losses on remeasurement of the net defined benefit asset or liability? (Topic 5)
6.	Can you account for past service costs, curtailments and settlements? (Topic 6)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Lampard	A short question, this will test whether you have understood the concept of past service costs.
Interest	This question focuses on the discount factor to be used in accounting for employee benefits in accordance with IAS 19.
Straw Holdings	The focus of this question is on giving advice to directors unsure how to apply IAS 19. You are also asked for the benefits of moving to a defined contribution plan, which is happening in practice.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios to help you improve knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Aytace (notes 2 and 3 only)	Note 2 requires the calculation (with explanation) of the defined benefit expense, including an improvement to the scheme. Note 3 requires calculation of a holiday pay accrual.

Maykem	This part of the question is based around correcting an incorrect treatment of the pension contribution and requires calculation of the loss on remeasurement and the required IAS 19 presentation in the financial statements.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries.

Once you have attempted these questions, you can continue your studies by moving onto the next chapter.

Technical reference

IAS 19, *Employee Benefits*

1 Four categories of employee benefits – IAS 19.4

- Short-term employee benefits
- Post-employment benefits
- Other long-term employee benefits
- Termination benefits

2 Short-term employee benefits – IAS 19.7, 19.8

- Wages, salaries and social security contributions falling due within 12 months of employee service
- Short-term compensated absences such as vacation entitlement and paid sick leave
- Profit-sharing and bonuses
- Non-monetary benefits

3 Accounting for short-term employee benefits – IAS 19.10

- Short-term employee benefits are recognised as an expense and a corresponding liability and are accounted for on an undiscounted basis

4 Post-employment benefits

- Classified as either:
- Defined contribution plans
- Where entity's legal or constructive obligation is limited to the amount it agrees to contribute to the fund and consequently bears no actuarial or investment risk
- Defined benefit plans
- Where entity provides agreed benefits and bears both actuarial and investment risk – **IAS 19.25, 19.26, 19.27**

5 Multi-employer plans – IAS 19.7

- Defined contribution or defined benefit plans that:
- Pool assets contributed by entities not under common control
- Provide benefits to employees of more than one entity with benefits determined without regard to the identity of the entity
- Defined benefit plans that share risks between entities under common control are not multi- employer plans – **IAS 19.34**

6 Recognition and measurement of defined contribution plans

Recognise as a liability and expense unless another standard allows inclusion in asset (eg, IAS 2 or IAS 16) – **IAS 19.44**

Disclose expense and required disclosure under – **IAS 24 IAS 19.46, 19.47**

7 **Recognition and measurement of defined benefit plans**

- Entity underwriting both investment and actuarial risk – **IAS 19.50**
- Accounting involves following steps:
  - Using actuarial techniques make reliable estimate of the amount of benefit employees earned in current and prior periods
  - Discount benefit using projected unit credit method
  - Determine fair value of plan assets
  - Determine total amount of remeasurement gains and losses to be recognised
  - Where plan introduced or changed determine resulting past service cost
  - Where plan has been curtailed or settled calculate resulting gain or loss – **IAS 19.50**

8 **Defined benefit scheme**

- Recognised in statement of financial position as the net of:
  - Present value of defined benefit obligation at reporting date, minus
  - Fair value at the reporting date of plan assets – **IAS 19.54**
- Recognised in profit or loss
  - Current service cost
  - Net interest on the net defined benefit liability (asset)
  - Past service cost
  - Effect of curtailments or settlements – **IAS 19.61**
- Recognised in other comprehensive income
  - Actuarial gains and losses
  - Returns on plan assets (excluding amounts in net interest) – **IAS 19.61**

9 **Actuarial assumptions**

- Shall be unbiased and mutually compatible
  - Demographic assumptions
  - Financial assumptions – **IAS 19.72**

10 **Discount rate – IAS 19.78**

- Rate used to discount post-employment obligations shall be determined by reference to market yields at reporting date on high quality corporate bonds

11 **Actuarial gains and losses**

- Gains and losses on remeasurement of plan assets and liabilities must be recognised in other comprehensive income (not reclassified to profit or loss) in the period in which they occur – **IAS 19.93 B**

12 **Past service cost**

- Arises when entity introduces defined benefit plan or changes benefit under an existing defined benefit plan – **IAS 19.97**
- Entity shall recognise past service cost as an expense in profit or loss – **IAS 19.96**

13 **Reimbursements – IAS 19.104A**

- An entity shall recognise its right to reimbursement as a separate asset only when it is virtually certain that another party will reimburse some or all of the expenditure required to settle a defined benefit obligation

14 Business combinations – IAS 19.108

- In a business combination (see IFRS 3, *Business Combinations*) an entity shall recognise assets and liabilities arising from post-employment benefits at the:
  - Present value of the obligation, less
  - Fair value of any plan assets
- The present value of the obligation includes all of the following even if not recognised by acquiree:
  - All actuarial gains and losses
  - Past service cost before acquisition date
  - Amounts not recognised under transitional provisions

15 Other long-term employee benefits

- Examples include sabbatical leave and long-term disability benefits – **IAS 19.126**
- Amount recognised as a liability is the net of the following:
  - Present value of the defined benefit obligation at the reporting date, minus
  - The fair value of plan assets at the reporting date – **IAS 19.128**
- Amount recognised in profit or loss is as for defined benefit schemes except that all actuarial gains and losses are recognised immediately in profit or loss – **IAS 19.127**

16 Termination benefits

- Termination benefits are recognised as an expense when the entity is committed to
  - Terminate the employment before normal retirement date, or
  - Provide termination benefits as a result of an offer for voluntary redundancy – **IAS 19.133**
- Where termination benefits fall due more than 12 months after the reporting date they shall be discounted – **IAS 19.139**

17 IAS 26, *Accounting and Reporting by Retirement Benefit Plans*

- Scope – **IAS 26.1**
- Definitions – **IAS 26.8**
- Defined contribution plans – **IAS 26.13**
- Defined benefit plans – **IAS 26.17–19**
- Frequency of actuarial valuations – **IAS 26.27**
- Financial statement content – **IAS 26.28–31**
- All plans:
  - Valuation of plan assets – **IAS 26.32**
  - Disclosure – IAS 26.34

Self-test questions

Answer the following questions

1 Employee benefits

Under which category of employee benefits should the following items be accounted for according to IAS 19, *Employee Benefits*?

Item	Category
Paid annual leave	
Lump-sum benefit of 1% of the final salary for each year of service	
Actuarial gains	

2 Lampard

The Lampard company operates two major benefit plans on behalf of its employees under which the amounts of benefit payable depend on a number of factors, the most important of which is length of service. The plans are:

(1) Plan Deben, a post-retirement defined benefit plan

(2) Plan Limen, a long-term disability benefits plan

Changes to the terms of these plans coming into effect from 31 December 20X7 will result in past service cost attributable to unvested benefits, to the extent of £500,000 on Plan Deben and £220,000 on Plan Limen. Within each plan the average period until benefits become vested is five years. There are no past service costs brought forward on either plan.

Requirement

Under IAS 19, *Employee Benefits*, what is the total amount of past service costs which must be recognised by Lampard in the year ended 31 December 20X7?

3 Tiger

The Tiger company operates a post-retirement defined benefit plan under which post-retirement benefits are payable to ex-employees and their partners.

For all the years this plan has been in operation, Tiger has used the market yield on its own corporate bonds as the rate at which it has discounted its defined obligation, because the yield on its own bonds has been the same as that on high-quality corporate bonds. In the current year Tiger has experienced a sharp downgrading in its credit rating, such that the yield on its own bonds at the year end is 8% while that on high-quality corporate bonds is 6%. Tiger is proposing to use the yield on its own bonds as the discount rate, to reflect the greater risk

Requirement

Indicate whether Tiger's approach is correct according to IAS 19, *Employee Benefits*.

4 Interest

An entity's defined benefit net liability at 31 December 20X4 and 20X5 is measured as follows

	20X4	20X5
	£	£
Defined benefit obligation	950,000	1,150,000

The discount rates used for calculating the defined benefit obligation were 6.5% at 31 December 20X4 and 6% at 31 December 20X5.

Requirements

4.1 Calculate the interest cost to be charged to profit or loss for 20X5.

4.2 How should the discount factor that is used to discount post-employment benefit obligations be determined?

4.3 What elements should the discount rate specifically not reflect according to IAS 19?

5 Straw Holdings plc

John Cork, financial director of Straw Holdings plc, your audit client, has recently written to you for advice on pension scheme accounting.

The company's defined benefit pension scheme has net assets valued at £20.2 million. Scheme assets of £19.4 million at the beginning of the year were expected to be enhanced by a cash contribution to the scheme of £0.4 million greater than payments to pensioners. An appropriate discount rate of 10% has been identified.

Based on these figures Mr Cork has prepared the following reconciliation.

Assets at 31 December 20X1

	£m
Opening scheme net assets	19.40
Add interest on assets @ 10%	1.94
Net contributions received	0.40
Less actuarial deficit (balancing figure)	(1.54)
Closing scheme net assets	20.20

The deficit of £1.54 million has come as a surprise to Mr Cork. He is unsure how to treat this deficit in the financial statements and is concerned about the impact it will have on the company's profits.

Requirements

5.1 Explain the impact of the actuarial valuation of the scheme's assets and the resultant deficit on the financial statements of Straw Holdings plc for the year ended 31 December 20X1.

5.2 Identify **two** benefits to Straw Holdings plc of moving from a defined benefit to a defined contribution scheme.

6 IAS 26

Answer the following questions in accordance with IAS 26, *Accounting and Reporting by Retirement Benefit Plans*.

6.1 How should a defined contribution retirement benefit plan carry property, plant and equipment used in the operation of the fund?

6.2 Is a defined contribution retirement benefit plan permitted to use a constant rate redemption yield to measure any securities with a fixed redemption value which are acquired to match the obligations of the plan?

6.3 Does IAS 26 specify a minimum frequency of actuarial valuations?

7 Commercial Properties plc

Commercial Properties plc is a construction company based in Leeds which specialises in the construction of manufacturing units and warehouses. You are conducting the audit for the year ended 31 December 20X8 and have obtained the following information.

The company has two warehouses which it lets to commercial tenants, one located in York and the other in Huddersfield. The property in York has been held for a number of years while construction of the property in Huddersfield was completed on 1 January 20X8 and then subsequently let.

The policy of the company in respect of investment properties is to carry them in the statement of financial position at open market value. They are revalued annually on the advice of professional surveyors at eight times the aggregate rental income.

In March 20X9 a rent review on the warehouse in York was implemented. The directors intend to base the valuation of this warehouse for the year ended 31 December 20X8 on this revised figure on the basis that this represents a more up to date assessment of the market value of the property.

The property in Huddersfield has been let on special terms to another company in which one of the directors holds an interest.

Commercial Properties plc also operates a defined benefit pension scheme on behalf of its employees. The actuary has performed an annual review of funding and based on these figures the statement of financial position is showing the pension fund as a net liability. There is an actuarial surplus on liabilities of £375,000 and a deficit on assets of £525,000. The discount rate determined by reference to market yields on high-quality fixed-rate corporate bonds is 12%.

Requirements

7.1 Identify and explain the audit issues regarding the two investment properties.

7.2 List the audit procedures you would perform to confirm the valuation of the properties.

7.3 List the audit procedures relating to the above pension scheme to be carried out as part of the 20X8 audit.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

The actuarial gain or loss is established as a balancing figure in the calculations, as follows.

Present value of obligation

	20X2 £'000	**20X3 £'000**	**20X4 £'000**
PV of obligation at start of year	1,000	1,200	1,600
Interest cost (10%)	100	120	160
Current service cost	140	150	150
Past service cost	–	–	40
Benefits paid	(120)	(140)	(150)
Settlements	–	(50)	–
Actuarial (gain)/loss on obligation: balancing figure	80	320	(100)
PV of obligation at end of year	1,200	*1,600	1,700

* (1,650 – 50)

Market value of plan assets

	20X2 £'000	**20X3 £'000**	**20X4 £'000**
Market value of plan assets at start of year	1,000	1,250	1,402
Interest on plan assets (10%)	100	125	140
Contributions	110	120	120
Benefits paid	(120)	(140)	(150)
Settlements	–	(48)	–
Gain on remeasurement through OCI: balancing figure	160	95	98
Market value of plan assets at year end	1,250	*1,402	1,610

* (1,450 – 48)

In the statement of financial position, the liability that is recognised is calculated as follows.

	20X2 £'000	**20X3 £'000**	**20X4 £'000**
Present value of obligation	1,200	1,600	1,700
Market value of plan assets	1,250	1,402	1,610
Liability/(asset) in statement of financial position	(50)	198	90

The following will be recognised in profit or loss for the year:

	20X2	20X3	20X4
	£'000	£'000	£'000
Current service cost	140	150	150
Past service cost	–	–	40
Net interest on defined benefit liability (asset)	–	(5)	20
Gain on settlement of defined benefit liability		(2)	
Expense recognised in profit or loss	140	143	210

The following remeasurements will be recognised in other comprehensive income for the year:

	20X2	20X3	20X4
	£'000	£'000	£'000
Actuarial (gain)/loss on obligation	80	320	(100)
Return on plan assets (excluding amounts in net interest)	(160)	(95)	(98)

Answer to Interactive question 2

Gains or losses on plan assets

	£'000
Fair value of plan assets at 1.1.20X5	5,200
Interest on plan assets (8% × £5,200)	416
Contributions	1,460
Benefits paid	(480)
Remeasurement gain to OCI (balancing figure)	204
Fair value of plan assets at 31.12.20X5	6,800

Gains or losses on obligation

	£'000
Present value of obligation at 1.1.20X5	5,800
Current service cost	900
Past service cost	180
Interest cost (8% × £5,800)	464
Benefits paid	(480)
Remeasurement loss to OCI (balancing figure)	136
Present value of obligation at 31.12.20X5	7,000

Answer to Interactive question 3

The defined benefit pension plan is treated in accordance with IAS 19, *Employee Benefits,* as revised in 2011.

The pension plan has a deficit of liabilities over assets.

	£m
Fair value of plan assets	200
Less present value of obligation	(208)
	(8)

The deficit is reported as a liability in the statement of financial position. Profit or loss for the year includes:

	£m
Current service cost	176
Net interest on net defined benefit liability (32 – 16)	16
	192

The company is required by the revised IAS 19 to recognise the £24,000,000 remeasurement gain (see working) immediately in other comprehensive income.

WORKING

	PV of obligation £m	FV of plan assets £m
b/f	Nil	Nil
Contributions paid		160
Interest on plan assets		16
Current service cost	176	
Interest cost on obligation	32	
Actuarial difference (bal fig)		24
c/f	208	200

Answer to Interactive question 4

Extracts as follows:

Statement of financial position extract	**£'000**
Non-current liabilities (4,115 – 4,540)	425

Statement of comprehensive income extract	**£'000**
Charged to profit or loss	
Current service cost	275
Net interest on net defined benefit liability (344 – 288)	56
Curtailment cost	58
	389

Other comprehensive income	£'000
Actuarial gain on obligation	107
Return on plan assets (excluding amounts in net interest)	7

Changes in the present value of the defined benefit obligation	£'000
Defined benefit obligation at 1 Feb 20X7	4,300
Interest cost @ 8%	344
Pensions paid	(330)
Curtailment	58
Current service cost	275
Actuarial gain (residual)	(107)
Defined benefit obligation at 31 Jan 20X8	4,540

Changes in the fair value of plan assets	£'000
Fair value of plan assets at 1 Feb 20X7	3,600
Contributions	550
Pensions paid	(330)
Interest on plan assets 8% × 3,600	288
Remeasurement gain (295 – 288)	7
Fair value of plan assets at 31 Jan 20X8 (residual)	4,115

Answer to Interactive question 5

The correct answer is:

A The general purpose financial reports of pension schemes

Answers to Self-test questions

1 Employee benefits

Item	Category
Paid annual leave	Short term employee benefits
Lump-sum benefit of 1% of the final salary for each year of service	Defined benefit plans
Actuarial gains	Defined benefit plans

IAS 19.9 highlights paid annual leave as a short-term benefit.

The actuarial gains and the lump-sum benefit relate to defined benefit plans (per IAS 19.24–27 and 54).

2 Lampard

£720,000 (£500,000 + £220,000)

Under IAS 19, *Employee Benefits* (revised 2011), past service cost attributable to all benefits, whether vested or not within a post-retirement defined benefit plan, must be recognised immediately in profit or loss. Similarly, past service cost attributable to all benefits, whether vested or not, within a long- term disability benefits plan must be recognised immediately in profit or loss, so the full £720,000 must be recognised.

3 Tiger

Tiger should not be using 8% as its discount rate.

Under IAS 19.78 the yield on high-quality corporate bonds must be used as the discount rate for the defined benefit obligation. (Using a higher rate would result in a lower obligation, which would not reflect greater risk.)

4 Interest

4.1 The interest cost for 20X5 is calculated by multiplying the defined benefit obligation at the start of the period by the discount rate at the start of the period, so: £950,000 × 6.5% = £61,750

4.2 The discount factor should be determined by reference to high-quality corporate bonds with similar currency and maturity as the benefit obligations.

Where no market in corporate bonds exists the discount rate should be determined by reference to government debt.

Where there is no deep market in corporate bonds with sufficiently long maturities the standard requires the use of current market rates of appropriate term to discount short-term payments and the estimation of the rate for longer maturities by extrapolating current market rates on the yield curves.

4.3 The discount rate should not reflect:

- investment risk
- actuarial risk
- specific risk relating to the entity's business

5 Straw Holdings plc

5.1 **Impact of actuarial valuation**

The plan assets are less than expected by £1.54 million, this being a remeasurement loss. Under IAS 19, *Employee Benefits* (revised 2011), such losses must be recognised in other comprehensive income in the period in which they occur. This would result in the net actuarial difference (the £1.54 million loss on the assets combined with any actuarial gain or loss on the obligation) being presented as other comprehensive income and debited directly to reserves. There would therefore be no direct impact on profit or loss.

5.2 Two benefits of moving to defined contribution scheme:

(1) Defined contribution schemes are easier for the company to administer and manage. A fixed level of contributions is paid in monthly instalments for each employee. The risk resulting from the variable returns achieved by funds invested is then borne by the employee. This risk is borne by the employer with a defined benefit scheme.

(2) Defined contribution schemes are easier to account for. Contributions are charged to profit or loss on a systematic basis.

Provided the company is not in arrears on contributions, the monthly double entry required is therefore:

		£	£
DEBIT	Staff costs	X	
CREDIT	Cash		X

6 IAS 26

6.1 Under IAS 26.33 all types of retirement benefit plan should account for assets used in the operation of the plan under the applicable standards. IAS 16 is applicable in this case and either the cost model or the revaluation model may be used.

6.2 All types of retirement plan are permitted by IAS 26.33 to use this method of measuring such securities.

6.3 No minimum frequency of actuarial valuation is specified in IAS 26.27 or elsewhere.

7 Commercial Properties plc

7.1 As follows:

- **Audit issues**
  - Whether the two warehouses fall within the IAS 40, *Investment Property* definition of an investment property
  - Based on the following evidence, it would appear that the definition is satisfied:
    - Both properties are held for the purposes of generating rental income
    - They are not owner occupied but let to third parties

- Whether the initial recognition of the newly completed warehouse is in accordance with IAS 40

  The property would normally be measured at cost during the period of construction (although IAS 40 does allow construction cost to be measured at fair value if it can be measured reliably).

- Whether the accounting treatment adopted for the subsequent measurement of the investment properties is in accordance with IAS 40

  Under IAS 40, a company may choose to adopt the cost model or the fair value model. Commercial Properties plc has adopted the fair value model. As a result of this, no depreciation should be charged and any changes in fair value should be recognised in profit or loss for the period.

- Whether the basis used as fair value is appropriate

  Rental income has been used as a basis of calculating an estimated fair value. This is a suitable basis, provided rentals are an indication of the market-based exit value at the measurement date.

  IFRS 13 states that fair value should reflect market conditions at the measurement date. The use of the revised rentals following the rent review therefore does not seem to be appropriate. This is because the rent reviews took place after the year end date and, at the end of the reporting period, would not have been guaranteed. As a result, they could not have been reflected in a fair value at 31 December 20X8.

  In accordance with IFRS 13, the market-based current exit price is based on the concept that an exchange between unrelated knowledgeable and willing parties has taken place. The warehouse in Huddersfield is being let to another company with which a director is associated. As a result of the relationship between the two parties the rent may not reflect market conditions and therefore may not be a suitable estimation of fair value.

- Whether there is a related party relationship

  The relationship between the director and the company leasing the warehouse in Huddersfield may constitute a related party transaction, which may require disclosure in the financial statements.

- Materiality

  The materiality of any adjustments required as a result of any changes to the fair values of the investment properties will need to be considered. As any changes in fair value are reflected in the statement of profit or loss and other comprehensive income, materiality will need to be assessed both in terms of the impact on the statement of financial position and on the statement of profit or loss and other comprehensive income.

Tutorial Note

This question contains a revision of the audit of investment properties, covered in earlier chapters.

7.2 As follows:

- **Audit procedures: investment properties**

- Obtain the report produced by the professional surveyors to confirm their valuation at eight times aggregate rental income, and to support the assumption that rentals provide an indication of an appropriate exit value in accordance with IFRS 13.

- Consider the extent to which their expertise can be relied on eg, reputable firm, experience etc.
- Obtain a copy of the rental agreement for the warehouse in York both before and after the rent review. Confirm that the year-end value has been based on the revised rent and calculate the adjustment which would be required if based on the initial agreement.
- Discuss the nature of the special terms on which the warehouse in Huddersfield has been let and the nature of the relationship between the director and the entity.
- Compare fair values as calculated by the directors with current prices for similar properties in similar locations.
- Where cash flows have been discounted, review whether any assumptions built in to the calculation are reasonable eg, discount rates used.
- Compare any proposed adjustments with materiality levels set for the audit.

7.3 As follows:

- **Audit procedures: pension scheme**
- Obtain the client's permission to liaise with the actuary, and review the actuary's professional qualification.
- Agree the validity and accuracy of the actuarial valuation.
  - Agree that the actuarial valuation method satisfies the accounting objectives of IAS 19.
  - Confirm that net interest cost has been based on the discount rate determined by reference to market yields on high-quality fixed-rate bonds.
- Agree the completeness of the actuarial valuation.
  - Identify major events that should have been taken into account.
  - Scrutinise relevant correspondence eg, between the client, the actuary, the solicitor.
  - Review minutes of board meetings.
- Agree opening balances to last year's working papers.
- Reconcile closing balance provision to opening statement of financial position.
- Agree contributions paid to the cash book and to the funding rate recommended by the actuary in the most recent actuarial valuation.
- Check that disclosures comply with the requirements of IAS 19.

- If fair values have been based on discounted cash flows, ie, future rentals, determine whether this is the most appropriate estimate of a market-based exit value. Compare predicted cash flows with rental agreements. Review the basis of the interest rate applied.
- Review documentation to support method used.
- Recalculate the gain or loss on change in fair value and agree to amount recognised in profit or loss.
- If fair value cannot be measured reliably confirm use of cost model.
- Agree disclosure is in accordance with IAS 40 and IFRS 13.

Chapter 19

Share-based payment

Introduction

Learning outcomes

- Appraise corporate reporting regulations, and related legal requirements, with respect to presentation, disclosure, recognition and measurement
- Explain how different methods of providing remuneration for employees may impact upon reported performance and position
- Explain and appraise accounting standards that relate to employee remuneration which include different forms of short-term and long-term employee compensation; retirement benefits; and share-based payment
- Justify and conclude for a particular scenario what comprises sufficient, appropriate audit evidence
- Design and determine audit procedures in a range of circumstances and scenarios, for example identifying an appropriate mix of tests of controls, analytical procedures and tests of details
- Demonstrate and explain, in the application of audit procedures, how relevant ISAs affect audit risk and the evaluation of audit evidence

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
1	**Background** In a working environment you may have to assess the effect of granting stock options as a remuneration policy on the entity's financial statements and advise on how these should be reported and disclosed. In major capital markets the potential gains that senior management can achieve through share-based payment transactions are so	**Approach** Read through this section quickly – it gives the background behind the publication of IFRS 2. **Stop and think** If the granting of equity instruments does not require the entity to part with assets, why should a charge be recognised in profit or loss?	Share-based payment is new to Advanced Level and is examinable at Level A. The reasons why IFRS 2 was needed will not be tested directly, but it helps to understand them in order to understand IFRS 2 itself.	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
	significant that they may dwarf other elements of remuneration packages.			
2	**Objective and scope of IFRS 2, *Share-based Payment*** The general principle of IFRS 2 is that an entity recognises an expense for goods or services with the credit entry recognised either in equity or as a liability depending on the classification of the share-based payment award.	**Approach** This is a short section with the key point being that there are three types of share-based payment: Equity-settled share-based payment transactions Cash-settled share-based payment transactions Transactions with a choice of settlement **Stop and think** Why has this been a controversial standard polarising views at the highest political level?	In your exam you will need to recognise and distinguish between these three types of share-based payment in order to get the financial reporting treatment right.	N/A
3	**Share-based transaction terminology** IFRS 2 has distinctive terminology that must be learned.	**Approach** Use the diagram in section 3 to understand what is going on before you approach the definitions. **Stop and think** What are market-based vesting conditions?	An exam will not ask for these definitions directly, but you will need to know them when tackling scenario-based questions.	N/A
4	**Equity-settled share-based payment transactions** The entity receives goods or services in exchange for equity instruments of the entity (including shares or share	**Approach** The key point is that the fair value of the transaction is recognised in profit or loss, spread over the vesting period. **Stop and think** Fair value has a	This topic is regularly examined. Typically you would need to identify that share options represent an equity-settled share-based payment and account for the share-based	**IQ2: Non-market-based vesting conditions** A short question in which the condition attached to the grant relates to employees still being in service at the vesting date.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
	options).	different definition from the IFRS 13 one, because share-based payments are outside the scope of IFRS 13.	payment correctly.	
5	**Cash-settled share-based payment transactions** The entity receives goods or services in exchange for amounts of cash that are based on the price (or value) of the entity's shares or other equity instruments of the entity.	**Approach** The key points are that: The credit entry in respect of a cash-settled share-based payment transaction is reported as a liability. The fair value of the liability should be remeasured at each reporting date until settled. Changes in the fair value are recognised in profit or loss. **Stop and think** Can you think of any examples of cash-settled share based payment transactions?	Cash-settled share-based payment transactions are examined as frequently as equity-settled. An exam scenario arose with a company deciding whether to use cash-based or equity-settled SBP.	**IQ6: Share-based payment** This question asks you to show the double entry for equity-settled SBP and to explain how this would be different if it were cash-settled.
6	**Share-based payment with a choice of settlement** The entity receives goods or services and either the entity or the supplier has a **choice** as to whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments.	**Approach** The key point is that the treatment depends on who has the choice. If the issuing entity has the choice recognise a liability to the extent that it has a present obligation to deliver cash. If the counterparty has the choice, use split accounting. **Stop and think** What should the treatment be if the issuing entity does	This is less frequently examined than when there is no choice.	**IQ7: Share-based payment** This is a more complex question with several 'what if' scenarios.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
		not have a present obligation to deliver cash?		
7	**Group and treasury share transactions** This is a fairly marginal topic.	**Approach** Read through quickly. **Stop and think** What are treasury shares?	This topic has not yet been examined.	N/A
8	**Disclosure** In a working environment you may need to advise on how the impact of share-based payment on an entity's financial performance and position should be reported and disclosed.	**Approach** Pay particular attention to section 8.4 (effect on financial performance and position). **Stop and think** How do share options affect earnings per share?	Disclosures don't tend to get tested in detail.	N/A There are no interactive questions relating to this section.
9	**Distributable profits and purchase of own shares** Dividends may only be paid out of distributable profits. There are strict rules relating to reduction of a company's capital.	**Approach** Distributable profits is revision from your earlier studies, so work though this quickly. Purchase of own shares is new to Advanced Level. **Stop and think** Why might a company wish to reduce its capital?	Distributable profits came up recently, when candidates were required to calculate the amount of a company's legally distributable reserves. In the past it has also come up as a combined FR/audit issue.	**IQ8: Main rules** A straightforward, bookwork question. If you're in a hurry, just highlight the main points in the answer.
10	**Audit focus** As is often the case, the auditor must focus on fair value: is the fair value of the payment appropriate?	**Approach** Use the table to determine the evidence required for each issue. **Stop and think** How would you audit the fair value of cash-settled SBP transactions?	As indicated earlier, share-based payment transactions can be tested from both the FR and the auditing standpoint.	**IQ10: Share-based payments** A short, audit-based question focusing on compliance with IFRS 2 and fair value and disclosure.

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Background

Section overview

Companies sometimes pay for goods and services provided to them in the form of shares or share options. This raises the issue of how such payments should be accounted for, and in particular whether they should be expensed in profit or loss.

1.1 Introduction

Share-based payment occurs when an entity purchases goods or services from another party such as a supplier or employee and rather than paying directly in cash, settles the amount owing in shares, share options or future cash amounts linked to the value of shares. This is common:

- in e-businesses which do not tend to be profitable in early years and are cash poor;
- within all sectors where a large part of the remuneration of directors is provided in the form of shares or options. Employees may also be granted share options.

1.2 The accounting problem

Pre-IFRS 2

Before the publication of IFRS 2, *Share-based Payment* there appeared to be an anomaly to the extent that if a company paid its employees in cash, an expense was recognised in profit or loss, but if the payment was in share options, no expense was recognised.

IFRS 2 requirements

As will be seen throughout the chapter, IFRS 2 requires an expense to be recognised in profit or loss in relation to share-based payments.

The publication of IFRS 2 in 2004 and introduction of this requirement to recognise an expense caused huge controversy, with opposition especially strong among high tech companies. The arguments over expensing share-based payments polarised opinion, especially in the US.

- The main argument against recording an expense was that no cash changes hands as part of such transactions, and it is claimed therefore that there is no true expense.
- The main argument for was that share-based payments are simply another form of compensation that should go into the calculation of earnings for the sake of transparency for investors and the business community. It was also argued that recording an expense better reflects the accruals basis of financial statement preparation.

Practical application of IFRS 2

In practice, the implementation of IFRS 2 has resulted in earnings being reduced, sometimes significantly. It is generally agreed that as a result of this standard companies focus more on the earnings effect of different rewards policies.

Following the adoption of IFRS 2, some companies have admitted that they are re-evaluating the use of share options as part of employee remuneration.

2 Objective and scope of IFRS 2, *Share-based Payment*

Section overview

A share-based payment transaction is one in which the entity transfers equity instruments, such as shares and share options, in exchange for goods and services supplied by employees or third parties.

2.1 Transactions within the scope of IFRS 2

IFRS 2 applies to all share-based payment transactions. The standard recognises and addresses **three** types of transactions according to the method of settlement.

- **Equity-settled share-based payment transactions**

  The entity receives goods or services in exchange for equity instruments of the entity (including shares or share options).

- **Cash-settled share-based payment transactions**

  The entity receives goods or services in exchange for amounts of cash that are based on the price (or value) of the entity's shares or other equity instruments of the entity.

- **Transactions with a choice of settlement**

  The entity receives goods or services and either the entity or the supplier has a **choice** as to whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments.

  IFRS 2 requires an entity to recognise share-based payment transactions in its financial statements. Transactions in which an entity receives goods or services as consideration for equity instruments of the entity (including shares or share options) are share-based payment transactions. Such transactions give rise to expenses (or, if applicable, assets) that should be measured at fair value.

  IFRS 2 was amended in 2009 to address situations in those parts of the world where, for public policy or other reasons, companies give their shares or rights to shares to individuals, organisations or groups that have not provided goods or services to the company. An example is the issue of shares to a charitable organisation for less than fair value, where the benefits are more intangible than usual goods or services.

  Note that the requirements of IFRS 13, *Fair Value Measurement* do not apply to share-based payment transactions within the scope of IFRS 2.

2.1.1 Share-based payments among group entities

Payment for goods or services received by an entity within a group may be made in the form of granting equity instruments of the parent company, or equity instruments of another group company.

IFRS 2.3 states that this type of transaction qualifies as a share-based payment transaction within the scope of IFRS 2.

In 2009, the standard was amended to clarify that it applies to the following arrangements:

- Where the entity's suppliers (including employees) will receive cash payments that are linked to the price of the equity instruments of the entity
- Where the entity's suppliers (including employees) will receive cash payments that are

linked to the price of the equity instruments of the entity's parent

Under either arrangement, the entity's parent had an obligation to make the required cash payments to the entity's suppliers. The entity itself did not have any obligation to make such payments. IFRS 2 applies to arrangements such as those described above even if the entity that receives goods or services from its suppliers has no obligation to make the required share-based cash payments.

2.2 Transactions outside the scope of IFRS 2

The following are outside the scope of IFRS 2:

- Transactions with employees and others in their capacity as a **holder of equity instruments** of the entity (for example, where an employee receives additional shares in a rights issue to all shareholders)
- The issue of equity instruments in exchange for control of another entity in a **business combination**
- Contracts to buy or sell non-financial items that may be settled **net** in shares or rights to shares are outside the scope of IFRS 2 and are addressed by IAS 32, *Financial Instruments: Presentation* and IFRS 9, *Financial Instruments*.

Context example: Transactions within and outside the scope of IFRS 2

Scenario 1: Entity A grants share warrants and its own equity to its external consultants. The warrants become exercisable once an initial public offering (IPO) is made and on condition that the consultants continue to provide agreed services to Entity A until the date the IPO is made.

This transaction is a share-based payment within the scope of IFRS 2.

Scenario 2: Entity B buys back some of its own shares from employees in their capacity as shareholders for the market value of those shares.

This transaction is a simple purchase of treasury shares and is outside the scope of IFRS 2, being governed instead by IAS 32.

Scenario 3: Entity C buys back some of its own shares but pays an amount in excess of their market value only to shareholders who are employees.

The excess over market value to employees only would be considered as a compensation expense within the scope of IFRS 2.

Scenario 4: Entity D enters into a contract to buy a commodity for use in its business for cash, at a price equal to the value of 1,000 shares of Entity D at the date the commodity is delivered. Although Entity D can settle the contract net, it does not intend to do so, nor does it have a past practice of doing so.

This transaction is within the scope of IFRS 2, as it meets the definition of a cash-settled share-based payment transaction. Entity D will be acquiring goods in exchange for a payment, the amount of which will be based on the value of its shares.

If, however, Entity D has a practice of settling these contracts net, or did not intend to take physical delivery, then the forward contract would be within the scope of IAS 32 and IFRS 9 and outside the scope of IFRS 2.

3 Share-based transaction terminology

Section overview

Share-based transactions are agreed between an entity and counterparty at the grant date; the counterparty becomes entitled to the payment at the vesting date.

Before considering the accounting treatment of share-based payment transactions, it is important to understand the terminology used within the topic.

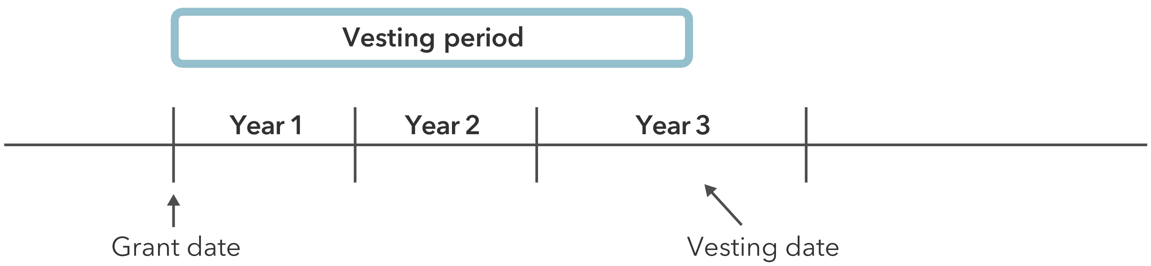


Figure 19.1: Vesting period

Definitions

Grant date: The date at which the entity and other party agree to the share-based payment arrangement. At this date the entity agrees to pay cash, other assets or equity instruments to the other party, provided that specified **vesting conditions**, if any, are met. If the agreement is subject to shareholder approval, then the approval date becomes the grant date.

Vesting conditions: The conditions that must be satisfied for the other party to become entitled to receive the share-based payment.

Vesting period: The period during which the vesting conditions are to be satisfied.

Vesting date: The date on which all vesting conditions have been met and the employee/third party becomes entitled to the share-based payment.

In some cases the grant date and vesting date are the same. This is the case where vesting conditions are met immediately and therefore there is no vesting period.

3.1 Vesting conditions

IFRS 2 recognises two types of vesting conditions:

Non-market-based vesting conditions

These are conditions other than those relating to the market value of the entity's shares. Examples include vesting dependent on:

- the employee completing a minimum period of service (also referred to as a service condition)
- achievement of minimum sales or earnings target
- achievement of a specific increase in profit or earnings per share
- successful completion of a flotation
- completion of a particular project

Market-based vesting conditions

Market-based performance or vesting conditions are conditions linked to the market price of the shares in some way. Examples include vesting dependent on achieving:

- a minimum increase in the share price of the entity
- a minimum increase in shareholder return
- a specified target share price relative to an index of market prices

Restricted definition of vesting conditions

The definition of vesting conditions:

- is restricted to service conditions and performance conditions; and
- excludes other features such as a requirement for employees to make regular contributions into a savings scheme.

Under IFRS 2, features of a share-based payment that are not vesting conditions should be included in the grant date fair value of the share-based payment. The fair value also includes market-related vesting conditions.

Vesting conditions and cancellations

Under IFRS 2, a failure to meet a condition, other than a vesting condition, is treated as a cancellation. Following a 2008 amendment, IFRS 2 specifies the accounting treatment of cancellations by the entity and gives guidance on the treatment of cancellations by parties other than the entity. The amendment requires cancellations by parties other than the entity to be accounted for in the same way as cancellations by the entity.

January 2018 amendment

IFRS 2 was amended in 2018. The 2018 amendments to IFRS 2 have a significant influence on the way companies measure and account for share-based payment transactions. Their purpose is to clarify issues which were not unambiguously defined in the existing standard and, in so doing, to reduce complexity in relation to measurement and classification. There are three areas of amendment:

(a) Classification of share-based payments that have a net settlement feature within the framework of an equity-settled plan

(b) Accounting for modifications that change the classification of payments from cash-settled to equity-settled

(c) The effects of vesting/non-vesting conditions on cash-settled share-based payments

4 Equity-settled share-based payment transactions

Section overview

Where payment for goods or services is in the form of shares or share options, the fair value of the transaction is recognised in profit or loss, spread over the vesting period.

4.1 Introduction

If goods or services are received in exchange for shares or share options, the transaction is accounted for by:

		£	£
DEBIT	Expense/Asset	X	
CREDIT	Equity		X

IFRS 2 does not stipulate which equity account the credit entry is made to. It is normal practice to credit a separate component of equity, although an increasing number of companies are crediting retained earnings.

We must next consider:

(a) Measurement of the total expense taken to profit or loss

(b) When this expense should be recorded

4.2 Measurement

When considering the total expense to profit or loss, the basic principle is that equity-settled share- based transactions are measured at fair value, as the amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction.

Note that this definition is still applicable, rather than the definition in IFRS 13, because IFRS 13 does not apply to transactions within the scope of IFRS 2.

Fair value will depend on who the transaction is with:

(a) There is a rebuttable presumption that the fair value of goods/services received from a **third party** can be measured reliably.

(b) It is not normally possible to measure services received when the shares or share options form part of the remuneration package of employees.

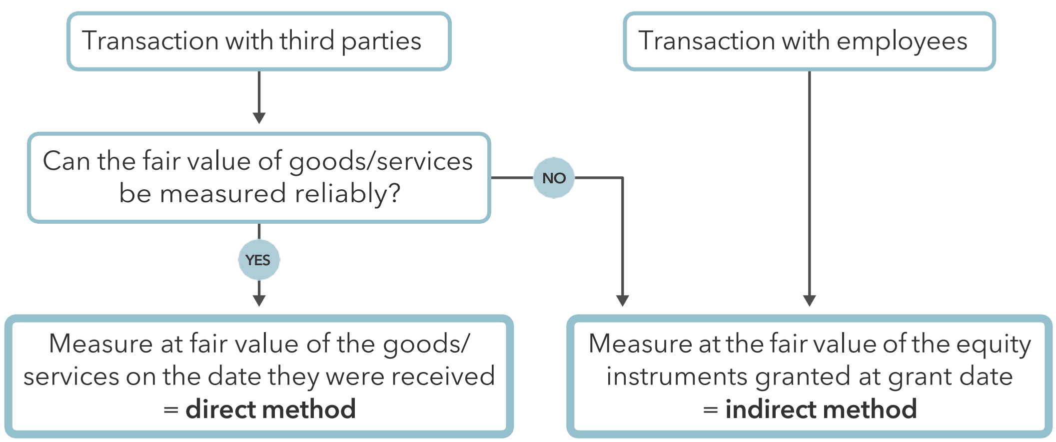


Figure 19.2: Measurement of equity-settled share-based transactions

Professional skills focus: Structuring problems and solutions

The above decision tree is one way to structure a problem if you are diagrammatically minded. This is particularly useful because IFRS 2 does not follow the usual fair value rules in IFRS 13.

4.3 Allocation of expense to financial years

Immediate vesting

Where the instruments granted vest immediately, i.e., the recipient party becomes entitled to them immediately, then the transaction is accounted for in full on the grant date.

Vesting period exists

Where entitlement to the instruments granted is conditional on vesting conditions, and these are to be met over a specified vesting period, the expense is spread over the vesting period.

4.4 Transactions with third parties (non-employees)

Applying the rules seen in the sections above, transactions with third parties are normally:

- measured at the fair value of goods/services received
- recorded when the goods/services are received

Worked example: Third-party transactions – direct method

Entity A has been paying Entity B, a corporate finance consultancy, in cash at the rate of £600 per hour for advice. Entity B is proposing to increase its fees by 5% per annum. Entity A is experiencing cash flow pressures, so it has persuaded Entity B to accept payment in the form of shares with effect from 1 July 20X5. The initial arrangement is for two years with Entity A agreeing to issue 6,000 of its shares to Entity B every six months in exchange for Entity B providing 300 hours of advice evenly over the six-month period.

Requirement

What is the expense in profit or loss and the corresponding increase in equity?

Solution

The services received and the shares issued by Entity A are measured at the fair value of the services received. For the first year, the hourly rate will be measured at that originally proposed by Entity B, 105% of £600. Entity B plans to increase that rate by another 5% for the second year.

The expense in profit or loss and the increase in equity associated with these arrangements will be:

		£
July – December 20X5	300 × £630	189,000
January – December 20X6	(300 × £630) + (300 × £630 × 1.05)	387,450
January – June 20X7	300 × £630 × 1.05	198,450

4.5 Transactions with employees

Applying the rules seen in the sections above, transactions with employees are normally:

- measured at the fair value of equity instruments granted **at grant date**; and
- spread over the vesting period (often a specified period of employment).

Worked example: Employee transactions – indirect method

A company provides each of 10 key employees with 1,000 share options on 1 January 20X7. Each option has a fair value of £9 at the grant date, £11 on 1 January 20X8, £14 on 1 January 20X9 and £12 on 31 December 20X9.

The options do not vest until 31 December 20X9 and are dependent on continued employment. All 10 employees are expected to remain with the company.

Requirement

What are the accounting entries to be recorded in each of the years 20X7, 20X8 and 20X9?

Solution

The changes in the value of equity instruments after grant date do not affect the charge to profit or loss for equity-settled transactions.

Based on the fair value at grant date, the remuneration expense is calculated as follows.

Number of employees × Number of equity instruments × Fair value of equity instruments at grant date

= 10 × 1,000 × £9 = £90,000

The remuneration expense should be recognised over the vesting period of three years. An amount of £30,000 should be recognised for each of the three years 20X7, 20X8 and 20X9 in profit or loss with a corresponding credit to equity.

Interactive question 1: Employee transactions

An entity provides each of its employees with 10 share options at 1 July 20X5, but the options do not vest until 30 June 20X7. The share options may be exercised after vesting date provided that the employees remain in the entity's employment.

The fair value of the share options is £20 on grant date and there are 1,500 employees in the entity's employment at 1 July 20X5.

Requirement

How should the entity account for the transaction if all employees remain in the entity's employment?

See **Answer** at the end of this chapter.

Professional skills focus: Assimilating and using information

Most problems involving share-based payments will be like the above example, with relatively small amounts of information. However, some will be longer, including complications like deferred tax.

4.5.1 Immediate vesting

Some share-based transactions with employees vest immediately. In this case, it is assumed that the relevant services have already been received and so the transaction is recognised on the grant date.

Worked example: Share options vest immediately

An entity issues 10 share options to each of its employees on 1 July 20X5. The share options vest immediately and there is a two-year period over which the employees may exercise the share options. Employees are entitled to exercise the options regardless of whether or not they remain in the entity's employment during the period of exercise. The fair value of the share options is £10 on grant date and there are 1,500 employees in the entity's employment at 1 July 20X5.

Requirement

How should the transaction be accounted for?

Solution

The total fair value for the share options issued at grant date is:

£10 × 1,500 employees × 10 options = £150,000

The entity should therefore charge £150,000 to profit or loss as employee remuneration on 1 July 20X5 and the same amount will be recognised as part of equity on that date.

4.6 The impact of different types of vesting conditions

As we have seen earlier, vesting conditions may be:

- non-market-based ie, not relating to the market value of the entity's shares; or
- market-based ie, linked to the market price of the entity's shares in some way.

4.6.1 Non-market-based vesting conditions

- These conditions are taken into account when determining the expense which must be taken to profit or loss in each year of the vesting period.
- Only the number of shares or share options expected to vest will be accounted for.
- At each period end (including interim periods), the number expected to vest should be revised as necessary.
- On the vesting date, the entity should revise the estimate to equal the number of shares or share options that do actually vest.

Worked example: Non-market-based vesting conditions

On 1 January 20X1 an entity grants 100 share options to each of its 400 employees. Each grant is conditional upon the employee working for the entity until 31 December 20X3. The fair value of each share option at the grant date is £20.

During 20X1 20 employees leave and the entity estimates that a total of 20% of the employees will leave during the three-year period.

During 20X2 a further 25 employees leave and the entity now estimates that 25% of its employees will leave during the three-year period.

During 20X3 a further 10 employees leave.

Requirement

Calculate the remuneration expense that will be recognised in respect of the share-based payment transaction for each of the three years ended 31 December 20X3.

Solution

IFRS 2 requires the entity to recognise the remuneration expense, based on the fair value of the share options granted, as the services are received during the three-year vesting period.

In 20X1 and 20X2 the entity estimates the number of options expected to vest (by estimating the number of employees likely to leave) and bases the amount that it recognises for the year on this estimate.

In 20X3 it recognises an amount based on the number of options that actually vest. A total of 55 employees left during the three-year period and therefore 34,500 options (400 – 55) × 100 vested.

The amount recognised as an expense for each of the three years is calculated as follows.

Cumulative expense

	at year end	Expense for year
	£	£
20X1 100 options × 400 employees × 80% × £20 × 1/3	213,333	213,333
20X2 100 options × 400 employees × 75% × £20 × 2/3	400,000	186,667
20X3 34,500 × £20 × 3/3	690,000	290,000

Interactive question 2: Non-market-based vesting conditions

On 1 January 20X3 an entity grants 500 share options to each of its 400 employees. The only condition attached to the grant is that the employees should continue to work for the entity until 31 December 20X6. 10 employees leave during the year, and it is expected that a further 10 will leave each year.

The market price of each option was £10 at 1 January 20X3 and £12 at 31 December 20X3.

Requirement

Show how this transaction will be reflected in the financial statements for the year ended 31 December 20X3.

See **Answer** at the end of this chapter.

Worked example: Non-market-based vesting conditions

On 1 January 20X4 an entity granted options over 10,000 of its shares to Sally, one of its senior employees. One of the conditions of the share option scheme was that Sally must work for the entity for three years. Sally continued to be employed by the entity during 20X4, 20X5 and 20X6.

A second condition for vesting is that the costs for which Sally is responsible should reduce by 10% per annum compound over the three-year period. At the date of grant, the fair value of each share option was estimated at £21.

At 31 December 20X4 Sally's costs had reduced by 15% and therefore it was estimated that the performance condition would be achieved.

Due to a particularly tough year of trading for the year ended 31 December 20X5 Sally had only reduced costs by 3% and it was thought at that time that she would not meet the cost reduction target by 31 December 20X6.

At 31 December 20X6, the end of the performance period, Sally did meet the overall cost reduction target of 10% per annum compound.

Requirement

How should the transaction be recognised?

Solution

The cost reduction target is a non market performance condition which is taken into account in estimating whether the options will vest. The expense recognised in profit or loss in each of the three years is:

	Cumulative	Charge in the year
	£	£
20X4 (10,000 × £21)/3 years	70,000	70,000
20X5 Assumed performance would not be achieved	0	(70,000)
20X6 10,000 × £21	210,000	210,000

Professional skills focus: Structuring problems and solutions

Share-based payment is a good example of where an answer can be structured and the structure applied routinely, so is a good source of relatively easy marks. The topic is likely to appear fairly regularly, as it is new to Advanced Level.

4.6.2 Market-based vesting conditions

- These conditions are taken into account when calculating the fair value of the equity instruments at the grant date.
- They are not taken into account when estimating the number of shares or share options likely to vest at each period end.
- If the shares or share options do not vest, any amount recognised in the financial statements will remain.

4.6.3 Market and non-market-based vesting conditions

Where equity instruments are granted with both **market** and **non-market** vesting conditions, paragraph 21 of IFRS 2 requires an entity to recognise an expense irrespective of whether market conditions are satisfied, provided **all other vesting conditions** are satisfied.

In summary, where **market** and **non-market** conditions coexist, it makes no difference whether the **market conditions** are achieved. The possibility that the target share price may not be achieved has already been taken into account when estimating the fair value of the options at grant date.
Therefore, the amounts recognised as an expense in each year will be the same regardless of what share price has been achieved. This is the case only with equity-settled share-based payment, not cash-settled share-based payment.

Worked example: Market and non-market vesting conditions

On 1 January 20X4 an entity granted options over 10,000 of its shares to Jeremy, one of its senior employees. One of the conditions of the share option scheme was that Jeremy must work for the entity for three years. Jeremy continued to be employed by the entity during 20X4, 20X5 and 20X6. A second condition for vesting is that the share price increases at 25% per annum compound over the three-year period. At the date of grant the fair value of each share option was estimated at £18 taking into account the estimated probability that the necessary share price growth would be achieved at 25%.

During the year ended 31 December 20X4 the share price rose by 30% and by 26% per annum compound over the two years to 31 December 20X5. For the three years to 31 December 20X6 the increase was 24% per annum compound.

Requirement

How should the transaction be recognised?

Solution

Jeremy satisfied the service requirement but the share price growth condition was not met. The share price growth is a market condition and is taken into account in estimating the fair value of the options at grant date. No adjustment should be made if there are changes from that estimated in relation to the market condition. There is no write-back of expenses previously charged, even though the shares do not vest.

The expense recognised in profit or loss in each of the three years is one-third of 10,000 × £18 = £60,000.

Interactive question 3: Market and non-market performance conditions

Company B issued 100 share options to certain employees, that will vest once revenues reach £1 billion and its share price equals £50. The employee will have to be employed with Company B at the time the share options vest in order to receive the options. The share options had a fair value of £20 at the grant date and will expire in 10 years.

Requirement

How should the expense be recorded under each of the following different scenarios?

(1) All options vest.

(2) Revenues have reached £1 billion, all employees are still employed and the share price is £49.

(3) The share price has reached £50, all employees are still employed but revenues have not yet reached £1 billion.

(4) Revenues have reached £1 billion, the share price has reached £50 and half the employees who received options left the company before the vesting date.

See **Answer** at the end of this chapter.

4.7 Other issues

4.7.1 Transactions during the year

Where the grant date arises mid year, the calculation of the amount charged to profit or loss must be pro-rated to reflect that fact.

Worked example: Options issued during the year

Yarex plc is proposing to award share options to directors and senior employees during the accounting year ending 31 December 20X6.

The proposal is to issue 100,000 options to each of the 50 directors and senior managers on 1 November 20X6.

The exercise price of the options would be £5 per share. The scheme participants will need to have been with the company for at least three years before being able to exercise their options.

It is estimated that 75% of the current directors and senior managers will remain with the company for three years or more.

	1 November 20X6	Average 20X6	31 December 20X6
	£	£	£
Price per share	5.00	5.50	5.80 (estimated)
Fair value of each option	2.00	2.40	3.80 (estimated)

Requirement

Show how the proposed scheme would be reflected in the financial statements on 31 December 20X6 and 31 December 20X7. Ignore taxation.

Solution

The three-year service condition specified by the options contract is a non-market vesting condition which should be taken into account when estimating the number of options which will vest at the end of each period. Therefore the proportion of directors expected to remain with the company is relevant in determining the remuneration charge arising from the options.

The fair value for the options used is the fair value at the grant date ie, the fair value of £2 on 1 November 20X6.

The remuneration expense in respect of the options for the year ended 31 December 20X6 is calculated as follows:

Fair value of options expected to vest at grant date:

(75% × 50 employees) × 100,000 options × £2 = £7,500,000 Annual charge to profit or loss

therefore £7.5m/3 years = £2.5m

Charge to profit or loss for y/e 31 December 20X6 = £2.5m × 2/12 months = £416,667 The

accounting entry for the year ending 31 December 20X6 is:

		£	£
DEBIT	Remuneration expense	416,667	
CREDIT	Equity		416,667

In 20X7 the remuneration charge is for the whole year. Assuming there is no change in the estimated retention rate for employees, the accounting entry is:

		£	£
DEBIT	Remuneration expense	2,500,000	
CREDIT	Equity		2,500,000

4.7.2 Vested options not exercised

If, after the vesting date, options are not exercised or the equity instrument is forfeited, there will be no impact on the financial statements. This is because the holder of the equity instrument has effectively made that decision as an investor.

The services for which the equity instrument remunerated were received by the entity and the financial statements reflect the substance of this transaction. IFRS 2 does, however, permit a transfer to be made between reserves in such circumstances to avoid an amount remaining in a separate equity reserve where no equity instrument will be issued.

4.7.3 Variable vesting date

Where the vesting date is variable depending on non-market-based vesting conditions, the calculation of the amount expensed in profit or loss must be based on the best estimate of when vesting will occur.

Interactive question 4: Variable vesting date

At the beginning of Year 1, Kingsley grants 100 shares each to 500 employees, conditional upon the employees remaining in the entity's employ during the vesting period. The shares will vest at the end of Year 1 if the entity's earnings increase by more than 18%; at the end of Year 2 if the entity's earnings increase by more than an average of 13% per year over the two-year period; and at the end of Year 3 if the entity's earnings increase by more than an average of 10% per year over the three- year period. The shares have a fair value of £30 per share at the start of Year 1, which equals the share price at grant date. No dividends are expected to be paid over the year period.

By the end of Year 1, the entity's earnings have increased by 14%, and 30 employees have left. The entity expects that earnings will continue to increase at a similar rate in Year 2, and therefore expects that the shares will vest at the end of Year 2. The entity expects, on the basis of a weighted average probability, that a further 30 employees will leave during Year 2, and therefore expects that 440 employees will vest in 100 shares at the end of Year 2.

By the end of Year 2, the entity's earnings have increased by only 10% and therefore the shares do not vest at the end of Year 2. 28 employees have left during the year. The entity expects that a further 25 employees will leave during Year 3, and that the entity's earnings will increase by more than 6%, thereby achieving the average of 10% per year.

By the end of Year 3, 23 employees have left and the entity's earnings had increased by 8%, resulting in an average increase of 10.64% per year. Therefore 419 employees received 100 shares at the end of Year 3.

Requirement

Show the expense and equity figures which will appear in the financial statements in each of the three years.

See **Answer** at the end of this chapter.

4.7.4 Modifications and repricing

Equity instruments may be modified before they vest.

Eg, a downturn in the equity market may mean that the original option exercise price set is no longer attractive. Therefore the exercise price is reduced (the option is 'repriced') to make it valuable again.

Such modifications will often affect the fair value of the instrument and therefore the amount recognised in profit or loss.

The accounting treatment of modifications and repricing is as follows:

(a) Continue to recognise the **original** fair value of the instrument in the normal way (even where the modification has reduced the fair value).

(b) Recognise any **increase** in fair value at the modification date (or any increase in the number of instruments granted as a result of modification) spread over the period between the modification date and vesting date.

(c) If modification occurs after the vesting date, then the additional fair value must be recognised immediately unless there is, for example, an additional service period, in which case the difference is spread over this period.

Worked example: Repricing of share options

An entity granted 1,000 share options at an exercise price of £50 to each of its 30 key management personnel on 1 January 20X4. The options only vest if the managers were still employed on 31 December 20X7. The fair value of the share options was estimated at £20 and the entity estimated that the options would vest with 20 managers. This estimate was confirmed on 31 December 20X4.

The entity's share price collapsed early in 20X5. On 1 July 20X5 the entity modified the share options scheme by reducing the exercise price to £15. It estimated that the fair value of an option was £2 immediately before the price reduction and £11 immediately after. It retained its estimate that options would vest with 20 managers.

Requirement

How should the modification be recognised?

Solution

The total cost to the entity of the original option scheme was:

1,000 shares × 20 managers × £20 = £400,000

This was being recognised at the rate of £100,000 each year. The cost of the modification is:

1,000 × 20 managers × (£11 – £2) = £180,000

This additional cost should be recognised over 30 months, being the remaining period up to vesting, so £6,000 a month.

The total cost to the entity in the year ended 31 December 20X5 is:

£100,000 + (£6,000 × 6) = £136,000.

Interactive question 5: Repricing of share options

At the beginning of Year 1, an entity grants 100 share options to each of its 500 employees. Each grant is conditional upon the employee remaining in service over the next three years. The entity estimates that the fair value of each option is £15. On the basis of a weighted average probability, the entity estimates that 100 employees will leave during the three-year period and therefore forfeit their rights to the share options.

During the first year, 40 employees leave. By the end of the first year, the entity's share price has dropped, and the entity reprices its share options. The repriced share options vest at the end of Year 3. The entity estimates that a further 70 employees will leave during Years 2 and 3, and hence the total expected employee departures over the three-year vesting period is 110 employees. During Year 2 a further 35 employees leave, and the entity estimates that a further 30 employees will leave during Year 3, to bring the total expected employee departures over the three-year vesting period to 105 employees. During Year 3, a total of 28 employees leave, and hence a total of 103 employees ceased employment during the vesting period. For the remaining 397 employees, the share options vested at the end of Year 3.

The entity estimates that, at the date of repricing, the fair value of each of the original share options granted (ie, before taking into account the repricing) is £5 and that the fair value of each repriced share option is £8.

Requirement

What are the amounts that should be recognised in the financial statements for Years 1 to 3?

See **Answer** at the end of this chapter.

4.7.5 Cancellations and settlements

An entity may settle or cancel an equity instrument during the vesting period. Where this is the case, the correct accounting treatment is as follows:

(a) To immediately charge any remaining fair value of the instrument that has not been recognised in profit or loss (the cancellation or settlement accelerates the charge and does not avoid it).

(b) Any amount paid to the employees by the entity on settlement should be treated as a buyback of shares and should be recognised as a deduction from equity. If the amount of any such payment is in excess of the fair value of the equity instrument granted, the excess should be recognised immediately in profit or loss.

Worked example: Cancellation

An entity granted 2,000 share options at an exercise price of £18 to each of its 25 key management personnel on 1 January 20X4. The options only vest if the managers are still employed by the entity on 31 December 20X6. The fair value of the options was estimated at £33 and the entity estimated that the options would vest with 23 managers. This estimate was confirmed on 31 December 20X4.

In 20X5 the entity decided to base all incentive schemes around the achievement of performance targets and to abolish the existing scheme for which the only vesting condition was being employed over a particular period. The scheme was cancelled on 30 June 20X5 when the fair value of the options was £60 and the market price of the entity's shares was £70. Compensation was paid to the 24 managers in employment at that date, at the rate of £63 per option.

Requirement

How should the entity recognise the cancellation?

Solution

The original cost to the entity for the share option scheme was:

2,000 shares × 23 managers × £33 = £1,518,000

This was being recognised at the rate of £506,000 in each of the three years.

At 30 June 20X5 the entity should recognise a cost based on the amount of options it had vested on that date. The total cost is:

2,000 × 24 managers × £33 = £1,584,000

After deducting the amount recognised in 20X4, the 20X5 charge to profit or loss is £1,078,000. The compensation paid is:
2,000 × 24 × £63 = £3,024,000

Of this, the amount attributable to the fair value of the options cancelled is:
2,000 × 24 × £60 (the fair value of the option, not of the underlying share) = £2,880,000 This is deducted from equity as a share buyback. The remaining £144,000 (£3,024,000 less £2,880,000) is charged to profit or loss.

4.7.6 Cancellation and reissuance

Where an entity has been through a capital restructuring or there has been a significant downturn in the equity market through external factors, an alternative to **repricing** the **share options** is to **cancel** them and issue new options based on revised terms. The end result is essentially the same as an entity modifying the original options and therefore should be recognised in the same way.

4.7.7 Cancellation by parties other than the entity

As well as the entity, other parties may cancel an equity instrument, for example the counterpart (eg, the employee) may cancel.

Cancellations by the employee must be treated in the same way as cancellations by the employer, resulting in an **accelerated charge to profit or loss of the unamortised balance of the options granted**.

4.7.8 Repurchase after vesting

Where equity instruments are repurchased by an employing entity following vesting, this is similar to the entity providing the employee with cash remuneration in the first instance. The reporting therefore reflects this, with the payment being recognised as a deduction from equity. The charge recognised in profit or loss will remain, as this reflects the services for which the employee has been remunerated. If the payment made is in excess of the fair value of the instruments granted, then this is recognised immediately in profit or loss reflecting that this is payment for additional services beyond what was originally agreed.

4.8 Determining the fair value of equity instruments granted

Where a transaction is measured by reference to the fair value of the equity instruments granted, **fair value** is based on **market prices** where available.

If **market prices** are not available, the entity should estimate the **fair value** of the equity instruments granted using a suitable **valuation technique**. These techniques are covered at Professional Level and in your Strategic Business Management Workbook.

4.8.1 Calculating fair value

Share options granted to employees do not generally have a readily obtainable market price because the conditions attached to the options usually make them different from other options that an entity may trade on the open market.

Where there is no readily obtainable market price an entity should use an **option pricing model** to calculate fair value. The type of option pricing model should reflect the nature of the options.
Employee options often have long lives and are generally exercisable between the vesting date and the end of the life of the option; the model used should allow for such circumstances.

All **option pricing models** take into account a number of factors as set out below.

(a) The **exercise price** of the option – a known amount.

(b) The **life of the option** – although the maximum life of the option is a known quantity, this input requires an estimate of the expected life of the individual option. Employee options, for example, are typically exercised soon after vesting date, as this is generally the only way that an employee can crystallise any gain.

(c) The **current price** of **the underlying shares** – this is generally a known amount (the listed market value of the shares).

(d) The **expected volatility of the share price** – volatility is typically expressed in annualised terms for ease of comparability. The expected annualised volatility of a share is expressed in terms of the compounded annual rate of return that is expected to arise approximately two-thirds of the time. Volatility (also discussed in detail in your Strategic Business Management Workbook) is a measure of the amount by which a share price is expected to fluctuate during a period. For example, a share worth £100 with a volatility of 40% would suggest that it will be worth between £60 and £140 approximately two-thirds of the time between the grant date and the exercise of the options.

(e) The **dividend expected** on the shares – this should only be included where the employee is not entitled to dividends on the underlying options granted.

(f) The **risk-free interest rate** for the life of the option – this is typically "the implied yield currently available on zero-coupon government issues of the country in whose currency the exercise price is expressed".

Factors which are typically used to assess volatility include the **historical volatility** of the entity's share price and the length of time that the shares have been publicly traded.

4.8.2 Which valuation model?

The determination of an appropriate model for the valuation of share-based payment transactions is an accounting policy choice and should be applied consistently to similar types of transactions.

In choosing an appropriate model the key question is whether the model used to estimate fair value represents the economics of the instruments and whether the inputs represent the attributes being measured.

The Black-Scholes model

The Black-Scholes-Merton formula (normally referred to as the Black-Scholes model) is a popular model and one that is easy to use. However, the model is based on the assumption that options are not exercised before the end of their lives and therefore may not be suitable for valuing employee share options. Where such options have a relatively short life and the period after vesting is short, the Black-Scholes model may provide a reasonable approximation of fair value.

Strengths

- The formula required to calculate fair value is relatively straightforward and can be easily used in excel.
- Its wide use enhances comparability.

Weaknesses

The inputs and assumptions of the Black-Scholes model are designed to cover the entire period the option is outstanding. Because of this feature the model is described as a 'closed form solution'.

- The model cannot therefore be adjusted to take into account anticipated changes in market conditions or incorporate different values for variables (such as volatility) over the term of the option as perceived at the grant date. The Black-Scholes model assumes constant volatility and cannot therefore be adjusted to take into account the empirical observation that the implied volatility of a share option changes as the intrinsic value of the option changes.
- The model cannot take into account the possibility of early exercise. This is less of an issue when options have to be exercised on or shortly after vesting.

The Binomial model

The Binomial model applies the same principles as decision tree analysis to the pricing of an option. Based on the relative probabilities of each path, an expected outcome is estimated.

In contrast to the Black-Scholes model, the Binomial model can incorporate different values for the variables over the term of the option. Therefore it is described as an 'open form solution' and it can be adjusted to take into account changes in market conditions and the input variables.

Strengths

- The Binomial model is generally accepted as a more flexible alternative to the Black-Scholes model.
- The inputs into the model are more suitable for an option with a longer term.

Weaknesses

- In practice, the application of the model is more complex than the Black-Scholes model. Whereas the Black-Scholes model allows the value of an option to be calculated using a relatively simple Formulae, the Binomial model requires a more complex formulae in excel or program to calculate the option value.
- The calculation of the probabilities of particular price movements is highly subjective.

Monte-Carlo simulation

Monte-Carlo simulation extends the Binomial model by undertaking thousands of simulations of potential future outcomes for key assumptions and calculating the option value under each scenario. Monte-Carlo models can incorporate very complex performance conditions and exercise patterns.

They are generally considered the best type of model for valuing employee share-based payments, although they are also affected by the subjectivity of probabilities.

5 Cash-settled share-based payment transactions

Section overview

- The credit entry in respect of a cash-settled share-based payment transaction is reported as a liability.
- The fair value of the liability should be remeasured at each reporting date until settled. Changes in the fair value are recognised in profit or loss.

5.1 Introduction

Cash-settled share-based payment transactions are transactions where the amount of cash paid for goods and services is based on the value of an entity's equity instruments.

Examples of this type of transaction include:

(a) share appreciation rights (SARs): the employees become entitled to a future cash payment (rather than an equity instrument), based on the increase in the entity's share price from a specified level over a specified period of time; or

(b) an entity might grant to its employees a right to receive a future cash payment by granting to them a right to shares that are redeemable.

5.2 Accounting treatment

If goods or services are received in exchange for cash amounts linked to the value of shares, the transaction is accounted for by:

		£	£
DEBIT	Expense/Asset	X	
CREDIT	Liability		X

Allocation of expense to financial years

The expense should be recognised as services are provided. For example, if share appreciation rights do not vest until the employees have completed a specified period of service, the entity should recognise the services received and the related liability, over that period.

Measurement

The goods or services acquired and the liability incurred are measured at the **fair value** of the **liability**.

The entity should **remeasure** the **fair value** of the liability at each reporting date and at the date of settlement. Any changes in fair value are recognised in profit or loss for the period.

Vesting conditions

Vesting conditions should be taken into account in a similar way as for equity-settled transactions when determining the number of rights to payment that will vest.

Worked example: Cash-settled share-based payment transaction

On 1 January 20X1 an entity grants 100 cash SARs to each of its 500 employees, on condition that the employees continue to work for the entity until 31 December 20X3.

During 20X1 35 employees leave. The entity estimates that a further 60 will leave during 20X2 and 20X3.

During 20X2 40 employees leave and the entity estimates that a further 25 will leave during

20X3. During 20X3 22 employees leave.

At 31 December 20X3 150 employees exercise their SARs. Another 140 employees exercise their SARs at 31 December 20X4 and the remaining 113 employees exercise their SARs at the end of 20X5.

The fair values of the SARs for each year in which a liability exists are shown below, together with the intrinsic values at the dates of exercise.

	Fair value	Intrinsic value
	£	£
20X1	14.40	
20X2	15.50	
20X3	18.20	15.00
20X4	21.40	20.00
20X5		25.00

Requirement

Calculate the amount to be recognised in profit or loss for each of the five years ended 31 December 20X5 and the liability to be recognised in the statement of financial position at 31 December for each of the five years.

Solution

For the three years to the vesting date of 31 December 20X3 the expense is based on the entity's estimate of the number of SARs that will actually vest (as for an equity-settled transaction). However, the fair value of the liability is remeasured at each year end.

The intrinsic value of the SARs at the date of exercise is the amount of cash actually paid.

	Liability at year end		Expense for year
	£	£	£
20X1 Expected to vest (500 – 95):			
405 × 100 × £14.40 × 1/3	194,400		194,400
20X2 Expected to vest (500 – 100):			
400 × 100 × £15.50 × 2/3	413,333		218,933
20X3 Exercised:			
150 × 100 × £15.00		225,000	
Not yet exercised (500 – 97 – 150):			
253 × 100 × £18.20	460,460	47,127	
			272,127
20X4 Exercised:			
140 × 100 × £20.00		280,000	
Not yet exercised (253 – 140):			
113 × 100 × £21.40	241,820	(218,640)	
			61,360
20X5 Exercised:			
113 × 100 × £25.00		282,500	
	Nil	(241,820)	
			40,680
			787,500

Interactive question 6: Share-based payment

J&B granted 200 options on its £1 ordinary shares to each of its 800 employees on 1 January 20X1. Each grant is conditional upon the employee being employed by J&B until 31 December 20X3.

J&B estimated at 1 January 20X1 that:

- the fair value of each option was £4 (before adjustment for the possibility of forfeiture); and
- approximately 50 employees would leave during 20X1, 40 during 20X2 and 30 during 20X3 thereby forfeiting their rights to receive the options. The departures were expected to be evenly spread within each year.

The exercise price of the options was £1.50 and the market value of a J&B share on 1 January 20X1 was £3.

In the event, only 40 employees left during 20X1 (and the estimate of total departures was revised down to 95 at 31 December 20X1), 20 during 20X2 (and the estimate of total departures was revised to 70 at 31 December 20X2) and none left during 20X3. The departures were spread evenly during each year.

The directors of J&B have asked you to illustrate how the scheme is accounted for under IFRS 2, *Share-based Payment*.

Requirements

6.1 Show the double entries for the charge to profit or loss for employee services over the three years and for the share issue, assuming all employees entitled to benefit from the scheme exercised their rights and the shares were issued on 31 December 20X3.

6.2 Explain how your solution would differ had J&B offered its employees cash, based on the share value rather than share options.

See **Answer** at the end of this chapter.

6 Share-based payment with a choice of settlement

Section overview

Accounting for share-based transactions with a choice of settlement depends on which party has the choice.

- Where the counterparty has a choice of settlement, a liability component and an equity component are identified.
- Where the entity has a choice of settlement, the whole transaction is treated either as cash-settled or as equity-settled, depending on whether the entity has an obligation to settle in cash.

6.1 Counterparty has the choice

Where the counterparty or recipient, rather than the issuing entity, has the right to choose the form settlement will take, IFRS 2 regards the transaction as a compound financial instrument to which split accounting must be applied.

This means that the entity has issued an instrument with a debt component in so far as the recipient may demand cash and an equity component to the extent that the recipient may demand settlement in equity instruments.

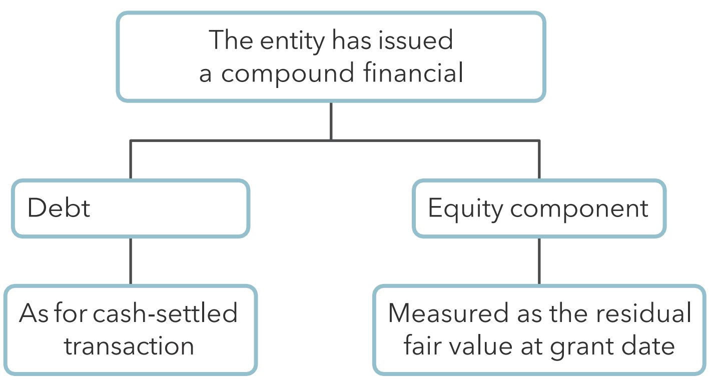


Figure 19.3: Choice of settlement

IFRS 2 requires that the value of the debt component is established first. The equity component is then measured as the residual between that amount and the value of the instrument as a whole. In this respect IFRS 2 applies similar principles to IAS 32, *Financial Instruments: Presentation* where the value of the debt components is established first. However, the method used to value the constituent parts of the compound instrument in IFRS 2 differs from that of IAS 32.

Fair value of goods or service = Fair value of debt component = Equity component (residual)

Figure 19.4: Compound instrument and IFRS 2

For transactions in which the fair value of goods or services is measured directly (that is, normally where the recipient is not an employee of the company), the fair value of the equity component is measured as the difference between the fair value of the goods or services required and the fair value of the debt component.

For other transactions including those with employees where the fair value of the goods or services is measured indirectly by reference to the fair value of the equity instruments granted, the fair value of the compound instrument is estimated as a whole.

The debt and equity components must then be valued separately. Normally transactions are structured in such a way that the fair value of each alternative settlement is the same.

Worked example: Choice of settlement

On 1 January 20X4 an entity grants an employee a right under which she can, if she is still employed on 31 December 20X6, elect to receive either 8,000 shares or cash to the value, on that date, of 7,000 shares.

The market price of the entity's shares is £21 at the date of grant, £27 at the end of 20X4, £33 at the end of 20X5 and £42 at the end of 20X6, at which time the employee elects to receive the shares. The entity estimates the fair value of the share route to be £19.

Requirement

Show the accounting treatment.

Solution

This arrangement results in a compound financial instrument. The fair value of the cash route is:
7,000 × £21 = £147,000

The fair value of the share route is:

8,000 × £19 = £152,000

The fair value of the equity component is therefore:

£5,000 (£152,000 less £147,000)

The share-based payment is recognised as follows:

			Liabilities	Equity	Expense
			£	£	£
20X4	1/3 × 7,000 × £27		63,000		63,000
	£5,000 × 1/3			1,667	1,667
20X5	2/3 × 7,000 × £33		154,000		91,000
	£5,000 × 1/3			1,667	1,667
20X6		7,000 × £42	294,000		140,000
		£5,000 × 1/3		1,667	1,667

As the employee elects to receive shares rather than cash, £294,000 is transferred from liabilities to equity at the end of 20X6. The balance on equity is £299,000.

Tutorial Note

In this example, which is based on the one in IFRS 2, there is only one employee. The standard is therefore unclear on whether the equity element should be adjusted for the number of employees. If there were 700 employees meeting the vesting conditions at grant date, expected to fall to 600 a year later for example. Both answers i.e., adjusting the equity element and not adjusting equity element would be accepted.

6.2 Entity has the choice

Where the entity may choose what form the settlement will take, it should recognise a liability to the extent that it has a present obligation to deliver cash. Such circumstances arise where, for example, the entity is prohibited from issuing shares or where it has a stated policy, or past practice, of issuing cash rather than shares. Where a present obligation exists, the entity should record the transaction as if it is a cash-settled share-based payment transaction. If no present obligation exists, the entity should treat the transaction as if it was purely an equity-settled transaction. On settlement, if the transaction was treated as an equity-settled transaction and cash was paid, the cash should be treated as if it was a repurchase of the equity instrument by a deduction against equity.

Interactive question 7: Share-based payment

Woodley plc is one of your assurance clients, and has asked you to advise on how to apply IFRS 2 to its new share option scheme. The company's reporting period is to 31 December.

The scheme is open to all 450 employees and all options are granted on 1 January 20X7. The fair value of each option is £15 on 1 January 20X7. The company estimates that this fair value will rise by approximately £5 per year. Each employee is given 100 options.

The vesting of the share option depends on achieving two independent targets. The first target is that the share price must have increased by a total of at least 10% in order for the options to vest.

The second target is that shares can vest when profits increase by 15% in any year, or by an average of 12% in any two years. The scheme will be cancelled after four years.

In 20X7, profits increase by 10% and the share price has risen by 5%. The shares do not vest, but at 31 December 20X7 the forecast increase in profits for 20X8 is 14%, and the forecast increase in share price for 20X8 is 5%. It is therefore anticipated the shares will vest in 20X8.

30 employees leave in 20X7 and it is estimated that a further 25 will leave before the options vest.

In 20X8, profits increase by 13% so the shares do not vest, although the share price target has now been achieved. 15 employees left during the year and it is anticipated that a further 26 will leave before the scheme is expected to vest in 20X9 (forecast profit increase for 20X9 is 12%).

In 20X9, profits increased by the forecast 12%, so the options vest. 390 employees ultimately received their options.

Requirements

7.1 Explain the principles of how this scheme should be measured and recognised. Calculate the IFRS 2 expense and set out the double entries required for 20X7, 20X8 and 20X9.

7.2 Describe how your answer would be different if in 20Y0, 100 employees allowed their vested share options to lapse.

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7.3 How would your answer to part 1 be different if the actual increase in profits for the year to 31 December 20X9 was 10% and, at that date, it was forecast that profits for 20Y0 were to increase by 15%, but the actual increase achieved in 20Y0 was 9%? If the targets related to share price and not profits, describe how to account for failing to meet the targets set.

See **Answer** at the end of this chapter.

7 Group and treasury share transactions

Section overview

IFRS 2 gives guidance on group and treasury share transactions.

7.1 Background

IFRS 2 gives guidance on group and treasury shares in three circumstances:

- Where an entity grants rights to its own equity instruments to employees, and then either chooses or is required to buy those equity instruments from another party, in order to satisfy its obligations to its employees under the share-based payment arrangement
- Where a parent company grants rights to its equity instruments to employees of its subsidiary
- Where a subsidiary grants rights to equity instruments of its parent to its employees

7.2 Accounting treatment

7.2.1 Entity chooses or is required to purchase its own shares

These transactions should always be accounted for as equity-settled share-based payment transactions under IFRS 2.

7.2.2 Parent grants rights to its equity instruments to employees of its subsidiary

Assuming the transaction is accounted for as equity-settled in the consolidated financial statements, the subsidiary must measure the services received using the requirements for equity-settled transactions in IFRS 2, and must recognise a corresponding increase in equity as a contribution from the parent.

7.2.3 Subsidiary grants rights to equity instruments of its parent to its employees

The subsidiary accounts for the transaction as a cash-settled share-based payment transaction.

Therefore, in the subsidiary's individual financial statements, the accounting treatment of transactions in which a subsidiary's employees are granted rights to equity instruments of its parent would differ, depending on whether the parent or the subsidiary granted those rights to the subsidiary's employees. This is because in the former situation, the subsidiary has not incurred a liability to transfer cash or other assets of the entity to its employees, whereas it has incurred such a liability in the latter situation (being a liability to transfer equity instruments of its parent).

8 Disclosure

Section overview

The disclosures of IFRS 2 are extensive and require the analysis of share-based payments made during the year, their impact on earnings and the financial position of the company and the basis on which fair values were calculated.

8.1 Nature and extent of share-based payment arrangements in the period

(a) A **description** of each type of share-based payment arrangement that existed at any time during the period, including the general terms and conditions of each arrangement.

The disclosure requirements of IFRS 2 are designed to enable the user of financial statements to understand:

- The nature and extent of share-based payment arrangements that existed during the period
- The basis upon which fair value was measured
- The impact of share-based transactions on earnings and financial position

(b) The **number and weighted average exercise prices** of share options for each of the following groups of options.

- Outstanding at the beginning of the period
- Granted during the period
- Forfeited during the period
- Exercised during the period (plus the weighted average share price at the time of exercise)
- Expired during the period
- Outstanding at the end of the period
- Exercisable at the end of the period

(c) For share options **exercised** during the period, the **weighted average share price** at the date of exercise.

(d) For share options **outstanding** at the end of the period, the range of exercise prices and weighted average remaining contractual life.

8.2 Disclosable transactions under IAS 24

Share-based payments in respect of key management personnel and related parties have to be disclosed in accordance with IAS 24, *Related Party Disclosures*.

8.3 Basis of fair value measurement

IFRS 2 requires disclosure of information that enables users of the financial statements to **understand how the fair value** of the goods or services received, or the fair value of the equity instruments granted, during the period **was determined**.

For equity instruments the disclosure of fair value methodology applies to both:

- new instruments issued during the reporting period; and
- existing instruments modified during the reporting period.

The entity must disclose the option pricing model used and the inputs to that model. These will include at least:

- the weighted average share price
- the exercise price
- the expected volatility of the share price
- the life of the option
- the expected dividends on the underlying share
- the risk-free interest rate over the life of the option
- the method used and the assumptions made to incorporate the effect of early exercise

8.4 Impact on earnings and financial position

Entities should also disclose information that enables users of the financial statements to understand the effect of share-based payment transactions on the entity's **profit or loss for the period** and on its **financial position**.

(a) The **total expense recognised for the period** arising from share-based payment transactions, including separate disclosure of that portion of the total expense that arises from transactions accounted for as equity-settled share-based payment transactions

(b) For **liabilities** arising from share-based payment transactions:

 (1) The **total carrying amount** at the end of the period

 (2) The **total intrinsic value** at the end of the period of liabilities for which the counterparty's right to cash or other assets had vested by the end of the period

The disclosure requirements of IFRS 2 are illustrated by an example below.

8.5 Model disclosures

(Note that comparative figures have been omitted from the disclosure.)

Share options are granted to both directors and employees, with the exercise price always set at the market price at the date of grant. Conditions of the options typically include sales growth and cost- reduction targets over a three-year period from the date of grant. Options which vest are exercisable over the subsequent four years.

For the year the number and weighted average exercise prices were as follows.

	Options	**Average exercise price**
		£
At start of year	163,000	2.00
Granted	50,000	3.00
Forfeited	(8,000)	–
Exercised	(30,000)	1.80
Expired	(6,000)	–
At end of year	169,000	2.40

Details of the 169,000 outstanding options are as follows:

- The range of exercise prices is £1.50 to £3.00 and the weighted average remaining life is 5.1 years.
- 72,000 are currently exercisable.

The weighted average share price at the date the 30,000 options were exercised during the year was £2.95.

The fair value of the options granted, all of which were granted on 18 June, was £5.60, based on the Black-Scholes model. The key inputs to that model were a weighted average share price of £3.50, an exercise price of £3.00, expected volatility (based on historic volatility) of 28% and a risk-free interest rate of 4% per annum.

The total expense for share options recognised in the year was £280,000.

8.6 Impact of share-based payments on earnings per share (EPS)

IAS 33, *Earnings per Share* requires that for calculating diluted EPS all dilutive options need to be taken into account. Employee share options with fixed terms and non-vested ordinary shares are treated as options outstanding on grant date even though they may not have vested on the date the diluted EPS is calculated. All awards which do not specify performance criteria are treated as options.

Employee share options contingent on performance-related conditions are treated as contingently issuable shares and are dealt with in detail in earlier chapters.

9 Distributable profits and purchase of own shares

Section overview

Various rules have been created to ensure that dividends are only paid out of **distributable profits**.

Definition

Dividend: An amount payable to shareholders from profits or other distributable reserves.

9.1 Power to declare dividends

A company may only pay dividends out of **profits available for the purpose.**

The power to declare a dividend is given by the articles which often include the following rules.

Rules related to the power to declare a dividend
The **company** in **general meeting** may declare dividends.
No dividend may exceed the **amount recommended** by the directors who have an implied power in their discretion to set aside profits as reserves.
The directors may declare such **interim dividends** as they consider justified.
Dividends are normally declared payable on the **paid-up amount** of **share capital**. For example, a £1 share which is fully paid will carry entitlement to twice as much dividend as a £1 share 50p paid.
A dividend may be paid **otherwise than in cash**.
Dividends may be paid by **cheque** or **warrant** sent through the post to the shareholder at his registered address or in any **electronic mode**. If shares are held jointly, payment of dividend is made to the first-named joint holder on the register.

Listed companies generally pay two dividends; an **interim dividend** based on interim profit figures, and a **final dividend** based on the annual accounts and approved at the AGM.

A **dividend becomes a debt** when it is **declared** and **due for payment**. A shareholder is not entitled to a dividend unless it is declared in accordance with the procedure prescribed by the articles and the declared date for payment has arrived.

This is so even if the member holds **preference shares** carrying a priority entitlement to receive a specified amount of dividend on a specified date in the year. The directors may decide to withhold profits and cannot be compelled to recommend a dividend.

If the articles refer to 'payment' of dividends this means **payment in cash**. A power to pay dividends **in specie** (otherwise than in cash) is not implied but may be expressly created. **Scrip dividends** are dividends paid by the issue of additional shares.

Any provision of the articles of association for the declaration and payment of dividends is subject to the overriding rule that **no dividend may be paid except out of profits distributable by law**.

9.2 Distributable profits

Tutorial note

Distributable profits may be defined as 'accumulated realised profits ... less accumulated realised losses'. **'Accumulated'** means that any losses of previous years must be included in reckoning the current distributable surplus. **'Realised'** profits are determined in accordance with generally accepted accounting principles.

Definition

Profits available for distribution: Accumulated realised profits (which have not been distributed or capitalised) less accumulated realised losses (which have not been previously written off in a reduction or reorganisation of capital).

The word **'accumulated'** requires that any **losses** of **previous years** must be included in reckoning the current distributable surplus.

A profit or loss is deemed to be **realised** if it is treated as realised in accordance with generally accepted accounting principles (GAAP). Hence, financial reporting and accounting standards in issue, plus GAAP, should be taken into account when determining realised profits and losses.

Depreciation must be treated as a **realised loss**, and debited against profit, in determining the amount of distributable profit remaining.

However, a **revalued asset** will have depreciation charged on its historical cost and the increase in the value in the asset.

Effectively there is a cancelling out, and at the end **only depreciation that relates to historical cost will affect dividends**.

Context example: Depreciation charge

Suppose that an asset purchased for £20,000 has a 10-year life. Provision is made for depreciation on a straight-line basis. This means the annual depreciation charge of £2,000 must be deducted in reckoning the company's realised profit less realised loss.

Suppose now that after five years the asset is revalued to £50,000 and in consequence the annual depreciation charge is raised to £10,000 (over each of the five remaining years of the asset's life).

The effect of the Act is that £8,000 of this amount may be reclassified as a realised profit. The net effect is that realised profits are reduced by only £2,000 in respect of depreciation, as before.

If, on a general revaluation of all fixed assets, it appears that there is a diminution in value of any one or more assets, then any related provision(s) need **not** be treated as a realised loss.

9.3 Dividends of public companies

A public company may only make a distribution if its **net assets are**, at the time, **not less than the aggregate of its called-up share capital and undistributable reserves**. The dividend which it may pay is limited to such amount as will leave its net assets at not less than that aggregate amount.

Undistributable reserves are defined as follows:

(a) Share premium account

(b) Capital redemption reserve

(c) Any surplus of accumulated unrealised profits over accumulated unrealised losses (known as a revaluation reserve). However, a deficit of accumulated unrealised profits compared with accumulated unrealised losses must be treated as a realised loss

(d) Any reserve which the company is prohibited from distributing by statute or by its constitution or any law

Context example: Permissible dividend

Suppose that a public company has an issued share capital (fully paid) of £800,000 and £200,000 on share premium account (which is an undistributable reserve). If its assets less liabilities are less than £1 million it may not pay a dividend. However, if its net assets are, say, £1,250,000 it may pay a dividend but only of such amount as will leave net assets of £1 million or more, so its maximum permissible dividend is £250,000.

The dividend rules apply to every form of distribution of assets except the following:

- The **issue of bonus shares** whether fully or partly paid
- The **redemption** or **purchase** of the company's **shares** out of **capital** or **profits**
- A **reduction** of **share capital**
- A **distribution** of **assets** to members in a **winding up**

You must appreciate how the rules relating to public companies in this area are more stringent than the rules for private companies.

Interactive question 8: Main rules

What are the main rules affecting a company's ability to distribute its profits as dividends? See

Answer at the end of this chapter.

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9.4 Relevant accounts

Tutorial note

The profits available for distribution are generally determined from the **last annual accounts** to be prepared.

Whether a company has profits from which to pay a dividend is determined by reference to its **'relevant accounts'**, which are generally the last annual accounts to be prepared.

If the auditor has qualified their report on the accounts they must also state in writing whether, in their opinion, the subject matter of their qualification is **material** in determining whether the dividend may be paid. This statement must have been circulated to the members (for a private company) or considered at a general meeting (for a public company).

A company may produce **interim accounts** if the latest annual accounts do not disclose a sufficient distributable profit to cover the proposed dividend. It may also produce **initial accounts** if it proposes to pay a dividend during its first accounting reference period or before its first accounts are laid before the company in general meeting. These accounts may be unaudited, but they must suffice to permit a proper judgement to be made of amounts of any of the relevant items.

If a **public** company has to produce initial or interim accounts, which is unusual, they must be full accounts such as the company is required to produce as final accounts at the end of the year. They need not be audited. However, the auditors must, in the case of initial accounts, satisfy themselves that the accounts have been 'properly prepared' to comply with the Act. A copy of any such accounts of a public company (with any auditors' statement) must be delivered to RJSC. Refer to Professional level Corporate Laws & Practices workbook for regulatory requirements relating to dividend.

If an unlawful dividend is paid by **reason of error** in the **accounts** the company may be unable to claim against either the directors or the members. The company might then have a claim against its **auditors** if the undiscovered mistake was due to negligence on their part.

Re London & General Bank (No 2) 1895

The facts: The auditor had drawn the attention of the directors to the fact that certain loans to associated companies were likely to prove irrecoverable. The directors refused to make any provision for these potential losses. They persuaded the auditor to confine his comments in his audit report to the uninformative statement that the value of assets shown in the statement of financial position 'is dependent on realisation'. A dividend was paid in reliance on the apparent profits shown in the accounts. The company went into liquidation and the liquidator claimed compensation from the auditor for loss of capital due to his failure to report clearly to members what he well knew was affecting the reliability of the accounts.

Decision: The auditor has a duty to report what he knows of the true financial position: otherwise his audit is 'an idle farce'. He had failed in this duty and was liable.

Professional skills focus: Concluding, recommending and communicating

The above case, in which the auditor was found wanting, shows that communication can fail by being too vague or incomplete, as well as by stating something misleading.

9.5 Purchase of own shares

> **Tutorial note**
>
> You must be able to carry out **simple calculations** showing the amounts to be transferred to the **capital redemption reserve** on purchase or redemption of own shares and how the amount of any **premium** on redemption would be treated.

Any limited company is permitted without restriction to cancel unissued shares and in that way to reduce its authorised share capital. That change does not alter its financial position. Refer to Professional level Corporate Laws & Practices workbook for regulatory requirements relating to reduction of share capital. There are **three basic methods of reducing share capital** specified.

(a) **Extinguish or reduce liability on partly paid shares**. A company may have issued £1 (nominal) shares 75p paid up. The outstanding liability of 25p per share may be eliminated altogether by reducing each share to 75p (nominal) fully paid or some intermediate figure eg, 80p (nominal) 75p paid. Nothing is returned to the shareholders but the company gives up a claim against them for money which it could call up whenever needed.

(b) **Cancel paid-up share capital which has been lost or which is no longer represented by available assets.** Suppose that the issued shares are £1 (nominal) fully paid but the net assets now represent a value of only 50p per share. The difference is probably matched by a debit balance on retained earnings (or provision for fall in value of assets). The company could reduce the nominal value of its £1 shares to 50p (or some intermediate figure) and apply the amount to write off the debit balance or provision wholly or in part. It would then be able to resume payment of dividends out of future profits without being obliged to make good past losses. The resources of the company are not reduced by this procedure of part cancellation of nominal value of shares but it avoids having to rebuild lost capital by retaining profits.

(c) **Pay off part of the paid-up share capital out of surplus assets.** The company might repay to shareholders, say, 30p in cash per £1 share by reducing the nominal value of the share to 70p. This reduces the assets of the company by 30p per share.

9.6 Share premium account

Whenever a company obtains for its shares a consideration in excess of their nominal value, it must transfer the excess to a share premium account. The general rule is that the **share premium account is subject to the same restriction as share capital**. **However, a bonus issue can be made using the share premium account** (reducing share premium in order to increase issued share capital).

The **other permitted uses of share premium** are to pay the following:

(a) Capital expenses such as preliminary expenses of forming the company

(b) Discount on the issue of shares or debentures

(c) Premium (if any) paid on redemption of debentures

Private companies (but not public companies) may also use a share premium account in purchasing or redeeming their own shares out of capital. Refer to Professional level Corporate Laws & Practices workbook for regulatory requirements relating to share premium account.

9.7 Practical reasons for purchase or redemption

Companies may wish to repurchase or redeem their issued shares for a variety of reasons.

(a) The company may have **surplus funds** for which it **cannot identify** sufficient **attractive business opportunities**.

(b) A reduction in the number of issued shares helps to **improve earnings per share (EPS)** and **return on capital employed** (ROCE).

(c) Dividend payments may be reduced, allowing the **cash** to be **used** for **other purposes**:

- funding operating activities
- capital expenditure
- repayment of debt

(d) The remaining shareholders' holdings will proportionately increase. Hence, even if the overall total dividends might not increase, some **shareholders** could receive **more cash individually**.

(e) Problem or **dissident shareholders** in private companies can be **paid off** and leave the company without spreading the membership of the company beyond the existing shareholders.

(f) It provides a potential **exit route** for **venture capitalists** who intend to be involved in the business for a limited period.

(g) It provides an **escape route** for **entrepreneurs** who have taken their companies to market to take them **back into private ownership**.

Refer to Professional level Corporate Laws & Practices workbook for regulatory requirements relating to Purchase or redemption by a company of its own shares

Note: Following IAS 32, **redeemable preference shares** are no longer classified as equity; they are classified as **financial liabilities**.

Context example: Capitalisation of profits

Suppose, for example, that Muffin Ltd decided to repurchase and cancel £100,000 of its ordinary share capital. A statement of financial position of the company is currently as follows.

	£
Assets	
Cash	100,000
Other assets	300,000
	400,000
Equity and liabilities	
Ordinary shares	130,000
Retained earnings	150,000
Trade payables	120,000
	400,000

Now if Muffin Ltd were able to repurchase the shares without making any transfer from the retained earnings to a capital redemption reserve, the effect of the share redemption on the statement of financial position would be as follows.

	£
Net assets	
Non-cash assets	300,000
Less trade payables	120,000
	180,000
Equity	
Ordinary shares	30,000
Retained earnings	150,000
	180,000

In this example, the company would still be able to pay dividends out of profits of up to £150,000. If it did, the creditors of the company would be highly vulnerable, financing £120,000 out of a total of £150,000 assets of the company.

The regulations in the Act are intended to prevent such extreme situations arising. On repurchase of the shares, Muffin Ltd would have been required to transfer £100,000 from its retained earnings to a non-distributable reserve, called a capital redemption reserve. The effect of the redemption of shares on the statement of financial position would have been:

	£	£
Net assets		
Non-cash assets		300,000
Less trade payables		120,000
		180,000
Equity		
Ordinary shares		30,000
Reserves		
Distributable (retained earnings)	50,000	
Non-distributable (capital redemption reserve)	100,000	
		150,000
		180,000

The maximum distributable profits are now £50,000. If Muffin Ltd paid all these as a dividend, there would still be £250,000 of assets left in the company, just over half of which would be financed by non-distributable equity capital.

When a company redeems some shares, or purchases some of its own shares, they **should be redeemed**:

(a) **out of distributable profits; or**

(b) **out of the proceeds of a new issue of shares.**

If there is any premium on redemption, **the premium must be paid out of distributable profits**, except that if the shares were issued at a premium, then any premium payable on their redemption may be paid out of the proceeds of a new share issue made for the purpose, up to an amount equal to the lesser of the following:

(a) The aggregate premiums received on issue of the shares

(b) The balance on the share premium account (including premium on issue of the new shares)

Context example: Repurchase of shares

A numerical example might help to clarify this point. Suppose that Just Desserts Ltd intends to repurchase 10,000 shares of £1 each at a premium of 5p per share. The redemption may be financed out of:

Distributable profits (10,000 × £1.05 = £10,500).

The proceeds of a new share issue (say, by issuing 10,000 new £1 shares at par). The premium of £500 must be paid out of distributable profits. Combination of a new share issue and distributable profits.

Out of the proceeds of a new share issue where the shares to be repurchased were issued at a premium. For example, if the shares had been issued at a premium of 3p per share, then (assuming that the balance on the share premium account after the new share issue was at least £300) £300 of the premium on redemption could be debited to the share premium account and only £200 need be debited to distributable profits.

(1) Where a company purchases its own shares wholly out of distributable profits, it must transfer to the capital redemption reserve an amount equal to the nominal value of the shares repurchased.

In this example, the accounting entries would be:

		£	£
DEBIT	Share capital account	10,000	
	Retained earnings (premium on redemption)	500	
CREDIT	Cash		10,500
DEBIT	Retained earnings	10,000	
CREDIT	Capital redemption reserve		10,000

(2) Where a company redeems shares or purchases its shares wholly or partly out of the proceeds of a new share issue, it must transfer to the capital redemption reserve an amount by which the nominal value of the shares redeemed exceeds the **aggregate** proceeds from the new issue (ie, nominal value of new shares issued plus share premium).

(3) In example (3) the accounting entries would be:

		£	£
DEBIT	Share capital account (redeemed shares)	10,000	
	Retained earnings (premium)	500	
CREDIT	Cash (redemption of shares)		10,500
DEBIT	Cash (from new issue)	10,000	
CREDIT	Share capital account		10,000

No credit to the capital redemption reserve is necessary because there is no decrease in the creditors' buffer.

(4) If the redemption in the same example were made by issuing 5,000 new £1 shares at par, and paying £5,500 out of distributable profits:

		£	£
DEBIT	Share capital account (redeemed shares)	10,000	
	Retained earnings (premium)	500	
CREDIT	Cash (redemption of shares)		10,500
DEBIT	Cash (from new issue)	5,000	
CREDIT	Share capital account		5,000
DEBIT	Retained earnings	5,000	
CREDIT	Capital redemption reserve		5,000

(5) In the example (4) above (assuming a new issue of 10,000 £1 shares at a premium of 8p per share) the accounting entries would be:

		£	£
DEBIT	Cash (from new issue)	10,800	
CREDIT	Share capital account		10,000
	Share premium account		800
DEBIT	Share capital account (redeemed shares)	10,000	
	Share premium account	300	
	Retained earnings	200	
CREDIT	Cash (redemption of shares)		10,500

No capital redemption reserve is required, as in (1) above. The redemption is financed entirely by a new issue of shares.

9.8 Commercial reasons for altering capital structure

These include the following:

- Greater security of finance
- Better image for third parties
- A 'neater' statement of financial position
- Borrowing repaid sooner
- Cost of borrowing reduced

Interactive question 9: Krumpet plc

Set out below is the summarised statement of financial position of Krumpet plc at 30 June 20X5.

	£'000
Net assets	520
Equity	
Called up share capital £1 ordinary shares	300
Share premium account	60
Retained earnings	160
	520

On 1 July 20X5 Krumpet plc purchased and cancelled 50,000 of its ordinary shares at £1.50 each.

The shares were originally issued at a premium of 20p. The redemption was partly financed by the issue at par of 5,000 new shares of £1 each.

Requirement

Prepare the summarised statement of financial position of Krumpet plc at 1 July 20X5 immediately after the above transactions have been effected.

See **Answer** at the end of this chapter.

10 Audit focus

Section overview

The auditor will need to evaluate whether the fair value of the share-based payment is appropriate.

The auditor will require evidence in respect of all the components of the estimated amounts, as well as reperforming the calculation of the expense for the current year.

Issue	Evidence
Number of employees in scheme/number of instruments per employee/length of vesting period	• Scheme details set out in contractual documentation
Number of employees estimated to benefit	• Inquire of directors • Compare to staffing numbers per forecasts and prediction
Fair value of instruments	• For equity-settled schemes confirm that fair value is estimated at the grant date • For cash-settled schemes confirm that the fair value is recalculated at the end of the reporting period and at the date of settlement • Confirm that model used to estimate fair value is in line with IFRS 2 and is appropriate to the conditions. Obtain expert advice on the valuation if appropriate
General	• Obtain representations from management confirming their view that: - the assumptions used in measuring the expense are reasonable; and - there are no share-based payment schemes in existence that have not been disclosed to the auditors.

Professional skills focus: Applying judgement

Fair value is an area where management exercises judgement and makes assumptions. The auditor needs to confirm that the assumptions are reasonable and the evidence sufficient.

Interactive question 10: Share-based payments

You are the auditor of Russell plc. The draft financial statements for the year ending 31 December 20X5 show a profit before tax of £400,000. Russell plc provided four of its directors with 3,000 share options each on 1 January 20X5 which vest on 31 December 20X7. The fair value of the options, determined by use of the Black-Scholes model, is as follows:

£10	At the grant date
£12	On 1 January 20X6
£15	On 1 January 20X7
£13	On 31 December 20X7

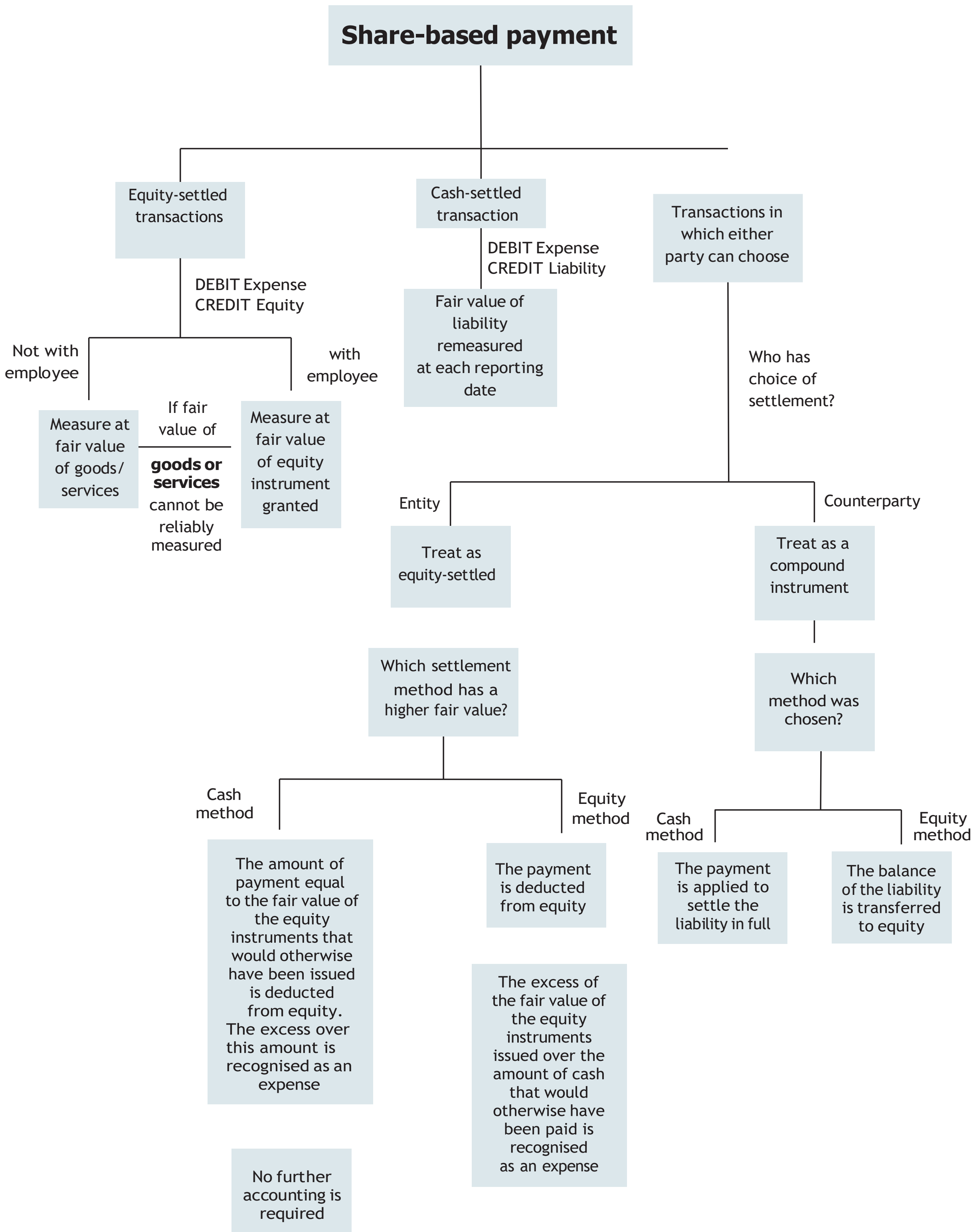
The options are dependent on continued employment. All four directors are expected to remain. No entry has been made in the financial statements of Russell plc in respect of the options on the basis that they do not vest until 31 December 20X7.

Requirement

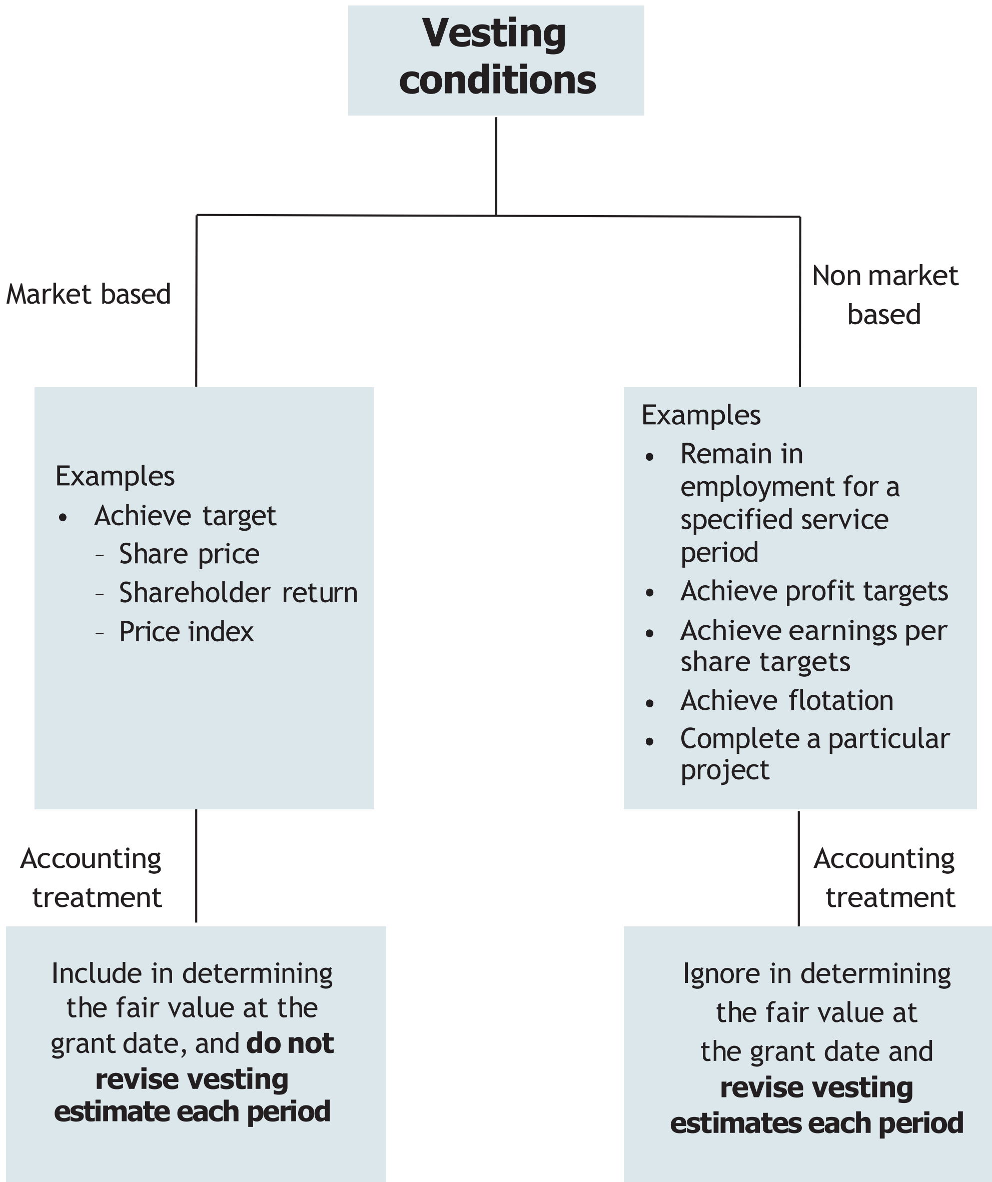
Identify the audit issues you would need to consider in respect of the share options.

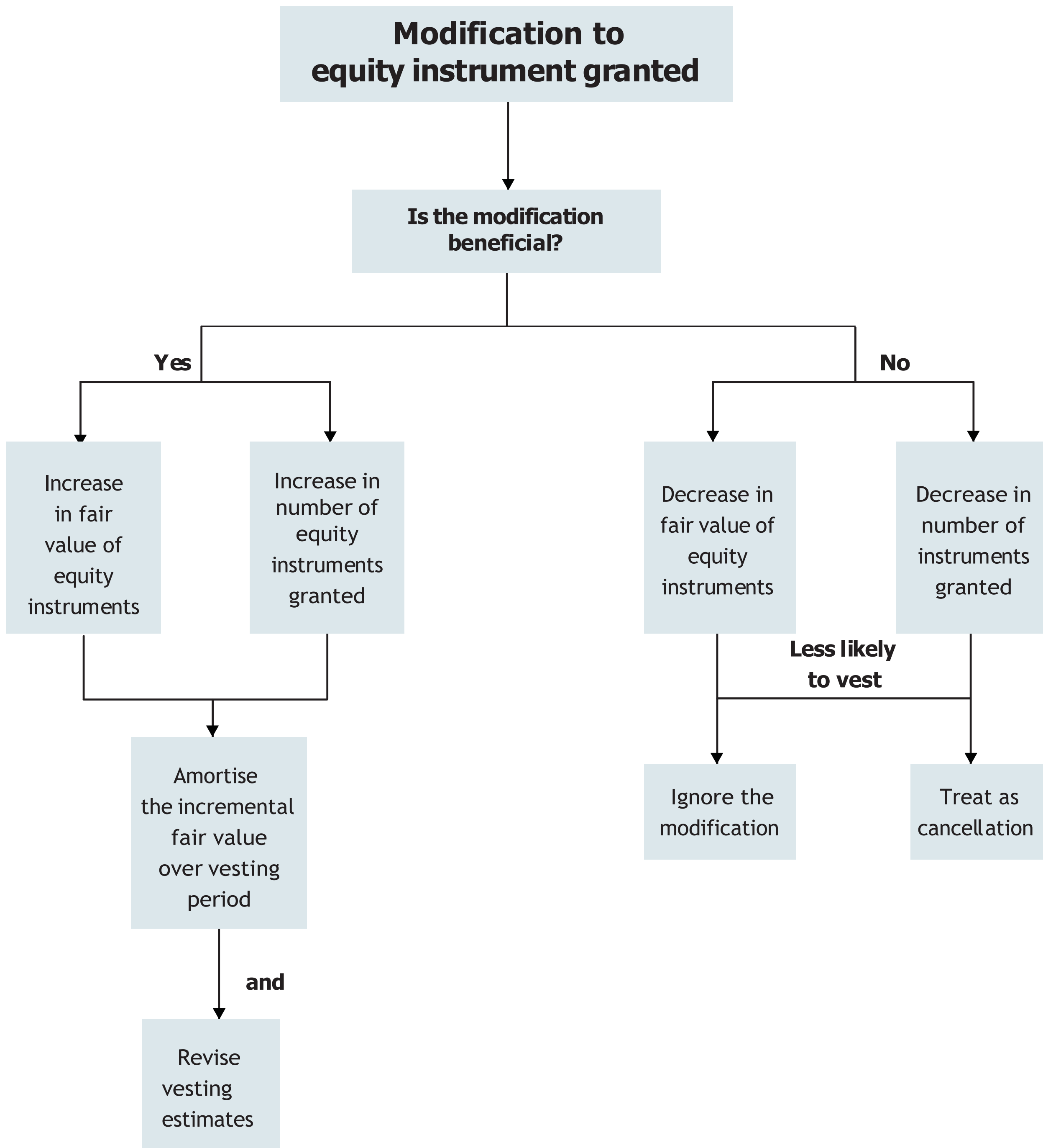
See **Answer** at the end of this chapter.

Summary



Share-based payment
Equity-settled transactions
DEBIT Expense
CREDIT Equity
Not with employee
with employee
Measure at fair value of goods/services
If fair value of
goods or services
cannot be reliably measured
Measure at fair value of equity instrument granted
Cash-settled transaction
DEBIT Expense
CREDIT Liability
Fair value of liability remeasured at each reporting date
Transactions in which either party can choose
Who has choice of settlement?
Entity
Counterparty
Treat as equity-settled
Treat as a compound instrument
Which settlement method has a higher fair value?
Which method was chosen?
Cash method
Equity method
Cash method
Equity method
The amount of payment equal to the fair value of the equity instruments that would otherwise have been issued is deducted from equity. The excess over this amount is recognised as an expense
No further accounting is required
The payment is deducted from equity
The excess of the fair value of the equity instruments issued over the amount of cash that would otherwise have been paid is recognised as an expense
The payment is applied to settle the liability in full
The balance of the liability is transferred to equity


Vesting conditions
Market based
Non market based
Examples
• Achieve target
– Share price
– Shareholder return
– Price index
Examples
• Remain in employment for a specified service period
• Achieve profit targets
• Achieve earnings per share targets
• Achieve flotation
• Complete a particular project
Accounting treatment
Accounting treatment
Include in determining the fair value at the grant date, and **do not revise vesting estimate each period**
Ignore in determining the fair value at the grant date and **revise vesting estimates each period**



Modification to equity instrument granted
Is the modification beneficial?
Yes
No
Increase in fair value of equity instruments
Increase in number of equity instruments granted
Decrease in fair value of equity instruments
Decrease in number of instruments granted
Less likely to vest
Amortise the incremental fair value over vesting period
and
Revise vesting estimates
Ignore the modification
Treat as cancellation

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Under IFRS 2, *Share-based Payment* what is an equity-settled share-based payment transaction? (Topic 2)
2.	What is the vesting period? (Topic 2)
3.	Can you distinguish between market and non-market vesting conditions? (Topic 3)
4.	Can you account for equity-settled and cash-settled share-based payment transactions? (Topic 4)
5.	Can you account for share-based payment transactions with a choice of settlement? (Topic 6)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Definition	This question is on equity-settled share-based payment and focuses on the explanation.
BCN	This covers share appreciation rights (cash-settled share-based payment) and focuses on the calculations.
Mayflower	This is an integrated question, set in the context of audit, covering other issues as well as share-based payment, as is likely to happen in an exam. If you're short of time, just skim-read the introductory paragraph for context and go straight to the section on share options.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios to help you improve knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Upstart (share options only)	You have already attempted other parts of this question. This part requires calculation and explanation of the correct treatment of equity-settled share-based payment.

Question	Learning benefit from attempting this question
Your Nature plc (share options only)	This part of a much longer question deals with share appreciation rights, and is a cash-settled share-based payment. Remember to re-measure the fair value of the liability at each year end.
Eastoak (share options only)	This is a more complex test of share-based payment with employees having the right to choose the form of settlement. In such cases IFRS 2 regards the transaction as a compound financial instrument, which must be split into debt and equity.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving onto the next chapter.

Technical reference

1 Three specific types of transactions

- Equity-settled share-based payment – **IFRS 2.2(a)**
- Cash-settled share-based payment – **IFRS 2.2(b)**
- Share-based payment transactions with a cash alternative – **IFRS 2.2(c)**

2 Transactions excluded from scope

- Transactions with employees in their capacity as shareholders – **IFRS 2.4**
- Issues of shares in a business combination – **IFRS 2.5**
- Contracts that may be settled net in shares or rights to shares – **IFRS 2.6**

3 Recognition

- Goods or services received in share-based transaction to be recognised as expenses or assets – **IFRS 2.8**
- Entity shall recognise corresponding increase in equity for equity-settled transaction or a liability for cash-settled transactions – **IFRS 2.7**

4 Equity-settled share-based transactions

- Goods or services received and corresponding increase in equity shall be measured as fair value of goods or services received (direct method) – **IFRS 2.10**
- If fair value of goods or services cannot be measured reliably, then measure at fair value of instruments granted – **IFRS 2.10**
- For transactions with third parties there is a presumption that the fair value of the goods or services can be estimated reliably – **IFRS 2.13**
- Fair value shall be measured at the date entity obtains the goods or counterparty renders service – **IFRS 2.13**
- If equity instruments vest immediately entity will recognise services received and corresponding increase in equity immediately – **IFRS 2.14**
- If equity instruments will be received in future, services and increase in equity will be recognised during vesting period – **IFRS 2.15**
- Fair value of equity instruments granted to be based on market prices if available – **IFRS 2.16**
- If market prices are not available a generally acceptable valuation technique should be used – **IFRS 2.17**
- Non-market vesting conditions shall be taken into account by adjusting the number of equity instruments included in the measurement of the transactions at each reporting date – **IFRS 2.19**
- For non-market vesting conditions the amount ultimately recognised will be the number of equity instruments that actually vest – **IFRS 2.19, 2.20**
- For grants of equity instruments with market conditions the entity shall recognise the goods or services from counterparty who satisfies all the other vesting conditions irrespective of whether market conditions are satisfied – **IFRS 2.21**

- Market conditions will be part of fair value at grant date. This should not be revised at each reporting date and where options do not vest the charge should not be reversed – **IFRS 2.21**
- If vested equity instruments are forfeited, entity shall make no adjustment to total equity except a transfer from one equity component to another – **IFRS 2.23**

5 Cash-settled share-based payment transactions

- Goods or services acquired should be measured at fair value of liability – **IFRS 2.30**
- Liability should be remeasured at each reporting date – **IFRS 2.30**

6 Share-based payment transaction with cash alternative

- If counterparty has right to choose then entity has granted a compound financial instrument with debt component and equity component – **IFRS 2.34**
- For counterparties other than employees, the equity component is measured as the difference between the fair value of the goods or services received and the fair value of the debt component (the counterparty's right to demand payment in cash) – **IFRS 2.35**
- For transactions with employees, the entity shall measure the fair value of the debt component and the fair value of the equity component separately and account for the debt component as a cash-settled transaction and the equity component as an equity-settled transaction – **IFRS 2.36, 2.37, 2.38**
- At the date of settlement the entity shall remeasure the liability to its fair value – **IFRS 2.39**
- Where equity instruments are paid instead of cash, the liability shall be transferred to equity – **IFRS 2.39**
- Where entity pays cash on settlement rather than equity, the payment is applied to the liability. The equity components previously recognised will remain in equity and entity can make a transfer from one component of equity to another – **IFRS 2.40**
- Where entity has the choice of settlement, if present obligation exists to deliver cash, it should recognise and treat as cash-settled share-based payment transaction – **IFRS 2.41**
- If no present obligation exists to pay cash, entity should treat transaction as an equity-settled transaction. On settlement if cash was paid, cash should be treated as repurchase of equity by a deduction against equity – **IFRS 2.43**

Self-test questions

Answer the following questions.

1 Share-based transactions

Which are the three types of share-based transactions covered by IFRS 2?

2 Definition

Which of the following transactions are NOT within the definition of a share-based payment under IFRS 2?

(1) Employee share ownership plans (ESOPs)

(2) Transfers of equity instruments of the parent of the reporting entity to third parties that have supplied goods or services to the reporting entity

(3) The acquisition of property, plant and equipment as part of a business combination

(4) Share appreciation rights (SARs)

(5) The raising of funds through a rights issue to all shareholders including those who are employees

(6) Cash bonus to employees dependent on share price performance

(7) Employee share purchase plans

(8) Remuneration in non-equity shares

3 BCN

BCN Co grants 1,000 share options to each of its 300 staff to be exercised in two years' time at a price of £6.10. The current fair value of the option is £1.40 and the expected fair value in two years' time is £2.40 (adjusted for the possibility of forfeiture in both cases). Under IFRS 2, *Share-based Payment*, how much expense would be recognised in profit or loss at the date of issue of the options?

4 Condition 1

On 1 January 20X3 an entity grants 250 share options to each of its 200 employees. The only condition attached to the grant is that the employees should continue to work for the entity until 31 December 20X6. Five employees leave during the year.

The market price of each option was £12 at 1 January 20X3 and £15 at 31 December 20X3.

Requirement

Show how this transaction will be reflected in the financial statements for the year ended 31 December 20X3.

5 Annerly

On 1 July 20X4 Annerly Co granted 20 executives options to buy up to 10,000 shares each. The options only vest if the executives are still in the service of the company on 1 July 20X6. It is estimated that 90% of the executives will remain with the company for the duration of the vesting period and exercise their options in full.

The following information is relevant.

- The exercise price of the option is £20 per share.
- The market value of each share was £15 on 1 July 20X4 and £18 on 30 June 20X5. It is £19 on 20 July 20X5, when the draft financial statements for the year to 30 June 20X5 are being reviewed.
- The market value of the option is £3 on 1 July 20X4, £3.20 on 30 June 20X5, and £2.50 on 20 July 20X5.

Requirement

How should the transaction be accounted for in the financial statements for the year to 30 June 20X5?

6 Condition 2

An entity grants 100 share options on its £1 shares to each of its 500 employees on 1 January 20X5. Each grant is conditional upon the employee working for the entity over the next three years. The fair value of each share option as at 1 January 20X5 is £15.

On the basis of a weighted average probability, the entity estimates on 1 January 20X5 that 20% of employees will leave during the three-year period and therefore forfeit their rights to share options.

Requirements

Show the accounting entries which will be required over the three-year period in the event of the following:

(a) 20 employees leave during 20X5 and the estimate of total employee departures over the three- year period is revised to 15% (75 employees).

(b) 22 employees leave during 20X6 and the estimate of total employee departures over the three- year period is revised to 12% (60 employees).

(c) 15 employees leave during 20X7, so a total of 57 employees left and forfeited their rights to share options. A total of 44,300 share options (443 employees × 100 options) vested at the end of 20X7.

7 Share appreciation rights

On 1 January 20X4 an entity grants 100 cash share appreciation rights (SARs) to each of its 500 employees on condition that the employees remain in its employ for the next two years. The SARs vest on 31 December 20X5 and may be exercised at any time up to 31 December 20X6. The fair value of each SAR at the grant date is £7.40.

Year ended	Leavers	No. of employees exercising rights	Outstanding SARs	Estimated further leavers	Fair value of SARs £	Intrinsic value* (ie, cash paid) £
31 Dec 20X4	50	–	450	60	8.00	
31 Dec 20X5	50	100	300	–	8.50	8.10
31 Dec 20X6	–	300	–	–	–	9.00

* Intrinsic value is the fair value of the shares less the exercise price

Requirement

Show the expense and liability which will appear in the financial statements in each of the three years.

8 ZZX plc

ZZX plc has provided a share incentive scheme to a number of its employees on 1 January 20X4. This allows for a cash payment to be made to the individuals concerned equal to the share price at the end of a three-year period subject to the following conditions.

(1) Vesting will be after three years.

(2) The share price must exceed £2.

(3) The employee must be with the company on 31 December 20X6.

Each scheme issued will result in payment, subject to the conditions outlined, equal to the value of 10 shares at the end of the three-year period if the conditions are satisfied. The payments, once earned, are irrevocable.

The finance director has been issued 20 such schemes. The share prices over the next three years were as follows.

- 31 December 20X4 = £2.20
- 31 December 20X5 = £1.80
- 31 December 20X6 = £2.40

Requirements

8.1 Prepare the journal entries for the transactions of the share incentives issued to the finance director.

8.2 Assuming that on 1 January 20X4 nine other individuals were also granted equivalent rights to the finance director and that on 1 January 20X5 two of those individuals left the company, prepare the journal entries for the transactions relating to the incentive schemes.

9 Kapping

The directors of Kapping are adopting IFRS for the first time and are reviewing the impact of IFRS 2, *Share-based Payment* on the financial statements for the year ended 31 May 20X7. They require you to do the following:

Requirements

9.1 Explain why share options, although having no cost to the company, should be reflected as an expense in profit or loss.

9.2 Discuss whether the expense arising from share options under IFRS 2 actually meets the definition of an expense under the IASB's *Conceptual Framework*.

9.3 Explain the impact of IFRS 2 on earnings per share, given that an expense is shown in profit or loss and the impact of share options is recognised in the diluted earnings per share calculation.

9.4 Briefly discuss whether the requirements of IFRS 2 should lead them to reconsider their remuneration policies.

10 Mayflower plc

Your firm has been working on a new audit assignment, Mayflower plc (Mayflower), a listed, diversified group of companies. Its main business interests include construction, publishing, food processing and a restaurant chain.

Mayflower's draft profit before tax for the year ended 31 March 20X8 is £17.5 million (20X7 £16.3 million) and its revenue is £234.5 million (20X7 £197.5 million).

The senior in charge of the audit for the year ended 31 March 20X8 has fallen ill towards the end of the audit and you are now helping to complete it. There are several matters outstanding and you will need to consider their impact on the financial statements and the audit. Your line manager has asked to meet you to discuss the significant outstanding matters. He has asked you to prepare briefing notes for the meeting, including your views on the impact on the financial statements and any additional audit work that might be required, so that a way forward can be agreed.

On reviewing the previous senior's notes you find the following outstanding areas:

Forward contract

On 1 April 20X6 Mayflower entered into a forward contract to purchase a large quantity of sugar on 1 April 20Y0. As far as we can tell, this was purely speculative based on the expectation that the price of sugar would rise. Mayflower did not pay to enter this contract. The company has not accounted for this contract in the years ended 31 March 20X7 or 20X8.

The finance manager of Mayflower has told us that at 31 March 20X7 the value of the contract had risen to £800,000 and by 31 March 20X8 its fair value had risen further to £850,000.

Share options

On 1 April 20X5 Mayflower provided three of its directors with 4,000 share options each, which vest on 1 April 20X8, assuming the directors remain in employment.

The fair values of each option were:

1 April	**£**
20X5	12
20X6	15
20X7	17
20X8	16

We have established that no accounting entries have been made for the above.

Debenture issue

Mayflower issued a £5 million convertible debenture at par on 1 April 20X7. The debenture has an annual nominal rate of interest of 4.5% and is redeemable on 1 April 20Y7 at par. Alternatively, the holder has the option to convert the debenture to four million £1 shares in Mayflower.

The debenture is presented as a non-current liability at the net proceeds and this amount has not changed since issue.

The directors have agreed to identify a suitable comparable debenture with an observable market rate of interest, but they have not yet done so.

Properties

The audit has verified the following facts about properties held by Mayflower:

PROPERTY	DESCRIPTION
Exeter House	Used as the company's head office.
33–39 Reeves Road	A warehouse held as a right-of-use asset that, up to six months ago, was used by Mayflower but has since been rented out to a third party on a short-term lease.
41–51 Reeves Road	A warehouse facility adjacent to the existing warehouse. This was purchased in November 20X7 at a cost of £3.8 million. Professional fees of £60,000 were also incurred. It is currently empty and has been since purchase, but a tenant is actively being sought.
Falcon House	An office block owned by Mayflower for seven years. It is currently all rented to a non-group company apart from a couple of small rooms in the basement that are used by Mayflower as an external store for some of its records.

Mayflower has classified all these properties as investment properties and has adopted the fair value model in accordance with IAS 40.

Since 31 March 20X8 property values have dropped by 2% on average.

We need to finalise their treatment as investment properties and verify their valuation.

Requirement

Prepare the required briefing notes on the financial reporting and auditing implications of each of the outstanding areas for discussion with your line manager.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

Fair value of options granted at grant date: 1,500 employees × 10 options × £20 = £300,000

This should be charged to profit or loss as employee remuneration evenly over the two-year period from 1 July 20X5 to 30 June 20X7.

£150,000 is recognised each year. A corresponding amount will be recognised as part of equity as the services are recognised.

Answer to Interactive question 2

The remuneration expense for the year is based on the fair value of the options granted at the grant date (1 January 20X3):

[400 employees – (10 leavers × 4 years)] × 500 options × £10 = £1,800,000.

Therefore, the entity recognises a remuneration expense of £450,000 (£1.8m/4 years) in profit or loss and a corresponding increase in equity of the same amount.

Answer to Interactive question 3

The total expense recorded over the expected vesting period would be as follows:

(1) All options vest: 100 options × £20 = £2,000 total expense

(2) All vesting conditions are met, except the market-based performance condition: 100 options × £20 = £2,000 total expense

(3) All vesting conditions are met, except the non-market-based performance condition: nil expense

(4) All vesting conditions are met, except half of the employees who received options left the company before the vesting date: 50 options × £20 = £1,000 total expense

Paragraph 21 of IFRS 2 states that the grant date fair value of the share-based payment with market- based performance conditions that has met all its other vesting conditions should be recognised, irrespective of whether that market condition is achieved. The company determines the grant date fair value of the share-based payment excluding the non-market-based performance factor, but including the market-based performance factor.

Answer to Interactive question 4

Expense/Equity figures

	Expense	Equity (per statement of financial position)
	£	£
Year 1	660,000	660,000
Year 2	174,000	834,000
Year 3	423,000	1,257,000

WORKINGS

(1) **Year 1**

Equity: (440 employees × 100 options × £30)/2 years = £660,000 (using original estimate of two-year period)

(2) **Year 2**

	£
Equity c/d [(500 – 30 – 28 – 25) employees × 100 × £30 × 2/3]	834,000
(using revised estimate of three-year period)	
Previously recognized	(660,000)
expense	174,000

(3) **Year 3**

	£
Equity c/d [(500 – 30 – 28 – 23) × 100 × £30]	1,257,000
Previously recognised	(834,000)
expense	423,000

Answer to Interactive question 5

The incremental value is £3 per share option (£8 – £5). This amount is recognised over the remaining two years of the vesting period, along with remuneration expense based on the original option value of £15.

The amounts recognised in Years 1–3 are as follows.

Year		£
1	Equity c/d [(500 – 110) × 100 × £15 × 1/3]	195,000
	DEBIT Expenses	£195,000
	CREDIT Equity	£195,000
2	Equity c/d [(500 – 105) × 100 × ((£15 × 2/3) + (£3 × 1/2))]	454,250
	Less previously recognised	(195,000)
		259,250
	DEBIT Expenses	£259,250
	CREDIT Equity	£259,250
3	Equity c/d [(500 – 103) × 100 × (£15 + £3)]	714,600
	Less previously recognised	(454,250)
		260,350
	DEBIT Expenses	£260,350
	CREDIT Equity	£260,350

Answer to Interactive question 6

6.1 **Accounting entries**

		£	£
	31.12.X1		
DEBIT CREDIT	Staff costs expense Equity reserve ((800–95) × 200 × £4 × 1/3)	188,000	188,000
	31.12.X2		
DEBIT	Staff costs expense (W1)	201,333	
CREDIT	Equity reserve		201,333
	31.12.X3		
DEBIT	Staff costs expense (W2)	202,667	
CREDIT	Equity reserve		202,667
	Issue of shares:		
DEBIT	Cash ((800 – 40 – 20) × 200 × £1.50)	222,000	
DEBIT	Equity reserve	592,000	
CREDIT	Share capital (740 × 200 × £1)		148,000
CREDIT	Share premium (balancing figure)		666,000

WORKINGS

(1) **Equity reserve at 31.12.X2**

	£
Equity c/d ((800 – 70) × 200 × £4 × 2/3)	389,333
Less previously recognized	(188,000)
charge	201,333

(2) **Equity reserve at 31.12.X3**

	£
Equity c/d ((800 – 40 – 20) × 200 × £4 × 3/3)	592,000
Less previously recognized	(389,333)
charge	202,667

6.2 **Cash-settled share-based payment**

If J&B had offered cash payments based on the value of the shares at vesting date rather than options, in each of the three years an accrual would be shown in the statement of financial position representing the expected amount payable based on the following:

No of employees estimated at the year end to be entitled to rights at the vesting date	×	Number of rights each	×	Fair value of each right at year end	×	Cumulative proportion of vesting period elapsed

The movement in the accrual would be charged to profit or loss representing further entitlements received during the year and adjustments to expectations accrued in previous years.

The accrual would continue to be adjusted (resulting in an expense charge) for changes in the fair value of the rights over the period between when the rights become fully vested and are subsequently exercised. It would then be reduced for cash payments as the rights are exercised.

Answer to Interactive question 7

7.1 Explanation

- Employee services – no reliable fair value Use fair value of the equity instrument
- Fair value measured at grant date – and not subsequently changed Expense in P/L over vesting period
- If vesting period can vary as a result of non-market conditions, use best estimate of length of period
- Best estimate of number that will vest
- Credit entry to equity – separate component or retained earnings

20X7

Expense is at fair value £15 based on an expected two-year vesting period 450 employees – 30 leavers – 25 future leavers = 395 employees

Expense = 395 × 100 options × £15 × 1/2 years

= £296,250

20X8

450 employees – 30 left Year 1 – 15 left Year 2 – 26 future leavers = 379 employees Expense is now spread over a three-year vesting period

Expense = £15 × 379 × 100 × 2/3 years	£379,000
Less recognised in Year 1	£296,250
Year 2 expense	£82,750
20X9	
390 × 100 × £15 × 3/3 years =	£585,000
Less recognised previously	£379,000
Expense in Year 3	£206,000

Double entries

		£	£
20X7			
DEBIT	Employment costs	296,250	
CREDIT	Equity		296,250
20X8			
DEBIT	Employment costs	82,750	
CREDIT	Equity		82,750
20X9			
DEBIT	Employment costs	206,000	
CREDIT	Equity		206,000

7.2 **20Y0**

If employees do not exercise their options, but allow them to lapse, the net expense recognised does not change. As long as the options vest, an expense will appear in the accounts.

7.3 In this case, the options would never vest. In 20X9, the expense would be extended to 20Y0 (effectively a four-year option scheme) before the scheme was cancelled in 20Y0 according to the initial details of the scheme. If the non-market condition was not achieved in 20Y0, the net expense recognised is reversed and a credit would appear in profit or loss for 20Y0 to the value of the previous cumulative expense recognised (in 20X9 this was £585,000). A market condition not being achieved would never affect the expense being recognised, as the share price movement is called 'volatility' which is included in the £15 fair value.

Answer to Interactive question 8

Dividends may only be paid by a company out of profits available for the purpose. There is a detailed code of statutory rules which determines what are distributable profits. The profits which may be distributed as dividend are accumulated realised profits, so far as not previously used by distribution or capitalisation, less accumulated realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made.

The word 'accumulated' requires that any losses of previous years must be included in reckoning the current distributable surplus.

The word 'realised' presents more difficulties. It may prevent the distribution of an increase in the value of a retained asset at fair value through profit or loss. However, it does not prevent a company from transferring to retained earnings profit earned on an uncompleted contract, if it is in accordance with generally accepted accounting principles. In view of the authority of accounting standards, it is unlikely that profits determined in accordance with accounting standards would be considered unrealised. A realised capital loss will reduce realised profits.

The above rules on distributable profits apply to all companies, private or public. A public company is subject to an additional rule which may diminish but cannot increase its distributable profit as determined under the above rules.

A public company may only make a distribution if its net assets are, at the time, not less than the aggregate of its called-up share capital and undistributable reserves. The dividend which it may pay is limited to such amount as will leave its net assets at not less than that aggregate amount.

Answer to Interactive question 9

WORKINGS FOR KRUMPET PLC

	£	£
Cost of redemption (50,000 × £1.50)		75,000
Premium on redemption (50,000 × 50p)		25,000
No premium arises on the new issue		
Distributable profits		
Retained earnings before redemption		160,000
Premium on redemption (25,000 – 5,000 charged to share premium account)		(20,000)
		140,000
Remainder of redemption costs	50,000	
Proceeds of new issue 5,000 × £1	(5,000)	
Remainder out of distributable profits		(45,000)
Balance on retained earnings		95,000

Statement of financial position of Krumpet plc as at 1 July 20X5

	£'000
Net assets (520 – 75 + 5)	450
Capital and reserves	
Ordinary shares (300 – 50 + 5)	255
Share premium: 60,000 less 5,000	
(10,000 allowable, being premium on original issue of 50,000 × 20p, restricted to proceeds of new issue of 5,000)	55
Capital redemption reserve	45
	355
Retained earnings (W)	95
	450

Answer to Interactive question 10

Audit issues:

- Consider compliance with IFRS 2. Based on the fair value at grant date (as provided) the total remuneration expense would be as follows:

4 × 3,000 × £10 = £120,000

The expense would then be recognised over the vesting period of three years. An amount of £40,000 should be recognised in 20X5 as an expense in profit or loss for the year with a corresponding credit in equity.

- The expense of £40,000 represents 10% of the profit before tax and is therefore likely to be material to the financial statements.
- Whether the basis of valuing fair value is appropriate. Ideally fair value should be based on market price if available. As the options have a relatively short life the valuation method used may provide a reasonable approximation to fair value.
- Adequacy of disclosure in accordance with IFRS 2.

Answers to Self-test questions

1 Share-based transactions

Share-based transactions covered by IFRS 2:

(1) Equity-settled share-based payment transactions

(2) Cash-settled share-based payment transactions

(3) Transactions with a choice of settlement

2 Definition

The following transactions are not within the definition of a share-based payment under IFRS 2:

(3) The acquisition of property, plant and equipment as part of a business combination. This is within the scope of IFRS 3, *Business Combinations*.
(5) The raising of funds through a rights issue to all shareholders including those who are employees. IFRS 2 does not apply to transactions with employees in their capacity as shareholders.
(8) Remuneration in non-equity shares.

Payment in non-equity shares does not fall within the scope of IFRS 2 since it is a transaction in which the entity receives goods and services in return for a financial liability.

3 BCN

No expense is recognised at the issue date of the options, but the expected benefit is accrued as a cost over the life of the option:

300 employees × 1,000 options × £1.40 = £420,000

This is spread equally over the two-year period to vesting, resulting in an annual charge to profit or loss of £210,000.

This would not be adjusted for any changes in expected benefit due to changes in expected share price as the value is measured at grant date, but is adjusted for the numbers of employees entitled to options at each reporting date.

4 Condition 1

The remuneration expense for the year is based on the fair value of the options granted at the grant date (1 January 20X3). As five of the 200 employees left during the year it is reasonable to assume that 20 employees will leave during the four-year vesting period and that therefore 45,000 options (250 × 180) will actually vest.

Statement of profit or loss and other comprehensive income	
Staff costs (45,000 × £12)/4 years	£135,000
Statement of financial position	
Equity	£135,000

5 Annerly

IFRS 2 requires that share-based transactions made in return for goods or services are recognised in the financial statements. The granting of options to the senior executives is a share-based payment under IFRS 2 and will need to be recognised as a remuneration expense. The amount to be charged as an expense is measured at the fair value of the goods or services provided as consideration for the share-based payment or at the fair value of the share-based payment, whichever can be more reliably measured.

In the case of employee share options, the market value of the options on the day these are granted is used, as this can be measured more reliably. The market value of the share options at the day these were granted, 1 July 20X4, was £3 each.

The exercise price for the option at £20 per share is above the market price on the date of issue on 1 July 20X4. This, however, does not mean that the option has zero market value. It has no intrinsic value, but it has what is referred to as time value relating to expectations of a share price increase over time.

The options vest at the end of the two-year period. The company expects that 90% of the options will vest, as it is estimated that 90% of the executives will remain in employment for the two-year period and thus be able to exercise their options in full.

The remuneration expense will be 10,000 × £3 × 20 × 90% = £540,000 and, as this vests over a two- year period, the entry to income for the current year to 30 June 20X5 will relate to half that amount: 1/2 × £540,000 = £270,000.

		£	£
DEBIT	Share-based payment remuneration expense	270,000	
CREDIT	Equity share-based payment reserve		270,000

When the shares are issued a transfer will be made from that reserve together with any further proceeds (if any) of the shares and will be credited to the share capital and share premium accounts.

6 Condition 2

(a) **Accounting entries**

			£
20X5 Equity c/d (500 × 85% × 100 × £15 × 1/3) =			212,500
DEBIT CREDIT	Expenses	£212,500	
	Equity		£212,500

(b) **Accounting entries**

			£
20X6 Equity c/d (500 × 88% × 100 × £15 × 2/3) =			440,000
Less previously recognised			(212,500)
			227,500
DEBIT CREDIT	Expenses	£227,500	
	Equity		£227,500

(c) **Accounting entries**

			£
20X7 Equity c/d (443 × 100 × £15) =			664,500
Less previously recognised			(440,000)
			224,500
DEBIT CREDIT	Expenses	£224,500	
	Equity		£224,500

CHAPTER 19

7 Share appreciation rights

Expense and liability

	£
Year ended 31 December 20X4	
Expense and liability ((450 – 60) × 100 × £8.00 × 1/2)	156,000
Year ended 31 December 20X5	
Liability c/d (300 × 100 × £8.50)	255,000
Less b/d liability	(156,000)
	99,000
Plus cash paid on exercise of SARs by employees	
(100 × 100 × £8.10)	81,000
Expense	180,000
Year ended 31 December 20X6	
Liability c/d	–
Less b/d liability	(255,000)
	(255,000)
Plus cash paid on exercise of SARs by employees	
(300 × 100 × £9.00)	270,000
Expense	15,000

8 ZZX plc

8.1 **Journal entries for transactions: finance director**

The transactions are settled in cash and hence liabilities are created.

31 December 20X4		£	£
DEBIT	Expense	147	
CREDIT	Liability		147

It is assumed that the current share price is the best estimate of the final share price.

(Calculation note: 20 × 10 × £2.20 × 1/3)

31 December 20X5		£	£
DEBIT	Liability	147	
CREDIT	Expense		147

Reverses entries for 20X4 as share price is less than minimum

31 December 20X6		£	£
DEBIT	Expense	480	
CREDIT	Liability		480
DEBIT	Liability	480	
CREDIT	Cash		480

(20 × 10 × £2.40 × 3/3)

8.2 **Journal entries for transactions: other individuals**

		£	£
31 December 20X4			
DEBIT	Expense	1,467	
CREDIT	Liability		1,467

(Calculation note: 20 × 10 × 10 × £2.20 × 1/3)

		£	£
31 December 20X5			
DEBIT	Liability	1,467	
CREDIT	Expense		1,467
31 December 20X6			
DEBIT	Expense	3,840	
CREDIT	Liability		3,840
DEBIT	Liability	3,840	
CREDIT	Cash		3,840

(Calculation note: 20 × 10 × 8 × £2.40 × 3/3)

9 Kapping

9.1 When shares are issued for cash or in a business combination, an accounting entry is needed to recognise the receipt of cash (or other resources) as consideration for the issue. Share options (the right to receive shares in future) are also issued in consideration for resources: services rendered by directors or employees. These resources are consumed by the company and it would be inconsistent not to recognise an expense.

9.2 The *Framework* defines an expense as a decrease in economic benefits in the form of outflows of assets or incurrences of liabilities. It is not immediately obvious that employee services meet the definition of an asset and therefore it can be argued that consumption of those services does not meet the definition of an expense. However, share options are issued for consideration in the form of employee services so that arguably there is an asset, although it is consumed at the same time that it is received. Therefore the recognition of an expense relating to share-based payment is consistent with the *Framework*.

9.3 It can be argued that to recognise an expense in profit or loss would have the effect of distorting diluted earnings per share as diluted earnings per share would then take the expense into account twice. This is not a valid argument. There are two events involved: issuing the options and consuming the resources (the directors' service) received as consideration.

The diluted earnings per share calculation only reflects the issue of the options; there is no adjustment to basic earnings. Recognising an expense reflects the consumption of services. There is no 'double counting'.

9.4 It is true that accounting for share-based payment reduces earnings. However, it improves the information provided in the financial statements, as these now make users aware of the true economic consequences of issuing share options as remuneration. The economic consequences are the reason why share option schemes may be discontinued. IFRS 2 simply enables management and shareholders to reach an informed decision on the best method of remuneration, weighing the advantages of granting these and their potential beneficial effect on motivation and corporate performance against the disadvantages of the impact on earnings.

10 Mayflower plc

Note: This question includes a revision of the audit of financial instruments and investment properties.

Forward contract Accounting issues

- At 31 March 20X7 there was an increase in the value of the derivative asset of £800,000 and this gain should have been included in profit or loss for the year ended 31 March 20X7.
- A prior year adjustment is needed in respect of the error of £800,000 not recognised in the opening balance. In accordance with IAS 8 this will be adjusted directly through reserves. The amount is likely to be material. Also the comparatives would need to be restated.
- The derivative will therefore be shown as an asset in the statement of financial position at £800,000 and £850,000 in the two years ended 31 March 20X7 and 20X8 respectively.

Audit procedures

- Review terms of the contract to determine the appropriate treatment ie, as a derivative financial asset
- The reason for the non-recognition of the fair value last year should be established and the systems for identifying and measuring forward contracts with zero initial values should be established
- General checks:
  - Obtain an understanding of the factors which affect the entity's derivative activities
  - Assess level of audit risk re the forward contract (and ensure audit procedures reduce the risk to an acceptable level)
  - Understand systems for dealing with forward contracts – ensure they cover authorisations, checking for completeness and accuracy, appropriate accounting for changes in values, ongoing monitoring, how errors are prevented and detected
  - Ensure data is secure
  - Check if there have been any margin settlements made
- Check the amounts at the year ends:
  - Inspect contract and confirm that Mayflower did not pay to enter the contract
  - Confirm no changes in contract
  - Assess the expertise and experience of the finance manager in determining the fair values and confirm that these have been derived in accordance with IFRS 13 (ie, Level 1 or Level 2 inputs)
  - Review documentation supporting information used by management including any assumptions made
  - Inquire whether management experts have been used to measure fair value and determine disclosures
  - Look for evidence of year-end fair values (quoted market price). The fair values of the forward contract would need to be attested. As sugar is traded on an active international market there should be sufficient publicly available information to observe the fair value of equivalent futures trades in an open market ie, in the principal market
  - Recalculate the value of the derivative asset
  - Obtain written representations from management

- Review events after the year end which may provide evidence about valuation at the period end

- Check IFRS 7 and IFRS 13 disclosure:
  - Accounting policy for financial instruments and how fair value is measured (valuation technique and inputs used)
  - Appropriate gains recognised in profit or loss for the year
  - Fair value ensuring the information can be compared with prior year
  - Nature and extent of risks arising

Share options Accounting issues

- IFRS 2 deals with this area.
- The total remuneration expense, based on the fair value at the grant date, would be: 3 × 4,000 × £12 = £144,000. This should have been spread evenly over the vesting period of three years assuming that there were no changes in assessment of when the directors would leave the company (and assuming that none of them have left). If there have been any variations over time as to the likelihood of the three directors being in post at vesting then there may be an adjustment to the amounts below (in particular if there was any change in numbers of shares vesting between last year and this year).
- This will necessitate a prior period adjustment of £144,000 × 2/3 = £96,000 which would be debited to retained earnings and credited to a share option reserve (or other appropriate reserve). As the standard only requires the credit to be posted to equity it is possible for no double entry to be posted at all (as retained earnings may substitute for a share option reserve). Regardless of how the accounting is reflected, the comparatives will need to be adjusted.
- The current year expense of £48,000 will be treated in the same way as above except that it will be included in profit or loss for the current year – most appropriately as a staff cost.

Audit procedures

- View documentation to verify option terms such as exercise price and term to vesting date.
- Ensure relevant directors are still employed.
- Investigate whether there was any indication that they might leave in the past, as this could affect the estimation basis of the prior period adjustment.
- Determine the basis on which the fair value of the options has been calculated – should be based on appropriate valuation based on market prices wherever possible. If an option pricing model has been used, determine which method has been adopted and whether it is appropriate and reflects the nature of the options.
- Confirm that the fair value is calculated as at the grant date and that this is when offer and acceptance has taken place.
- Recalculate the fair value using the same inputs and consider obtaining expert advice if appropriate.
- Check volatility to published statistics.
- Agree share price at issue to market price on that date.
- Agree risk-free rate appropriate at time of granting options.
- Assess whether there are any terms of the share option which give the directors a choice of exercise through cash receipt as opposed to exercising the share options.
- Recalculate the expense spread over the vesting period.
- Obtain written representations from management confirming their view that any assumptions they have used in measuring fair value are reasonable and that there are no

further share-based payment schemes in existence that have not been disclosed.

- Check disclosure is in accordance with IFRS 2.

Debenture Accounting issues

- The current treatment of leaving the debenture at the value of the net proceeds does not comply with IFRS 9 and IAS 32, as there has been no accounting for the post-issue finance costs and the fact that the instrument is a hybrid instrument which needs to be split into liability and equity components.
- Calculate the liability element as the present value of the cash flows of the debenture, discounted at the market rate of interest for comparable borrowings with no conversion rights. This will require some attention on our part, to ensure that an appropriate interest rate has been selected.
- Classify as equity the remainder of the proceeds representing the fair value of the right to convert.
- The market rate of interest should then be used to unwind the discounting for the current year which will bring the liability closer to the final redemption value and allocate an appropriate finance charge to profit or loss. The annual interest payment will also be recorded as a cash flow and will reduce the liability.

Audit procedures

- Review debenture deed and agree nominal interest rates and conversion terms.
- Review calculation of the fair value of the liability at the date of issue.
- Confirm appropriate discount rate used by reference to external market while considering if market rates are representative of the instrument issued.
- We should discuss and assess the reasons for the selection of the rate by management and the assumptions made.
- We should review interest rates associated with companies in the industries which make up Mayflower's core interests and also some conglomerates (even though the mix is highly unlikely to be anything like Mayflower's) and compare these with the rate selected by management. We could also perform a sensitivity analysis, if a material risk is identified, in order to quantify the effect of changing the interest rate.
- Agree calculation of amortised cost after it has been performed by the directors.
- Agree initial proceeds and interest payments to records and bank statement.
- Review disclosures and ensure in accordance with IAS 32, IFRS 9, IFRS 7 and IFRS 13.

Properties Accounting issues

Classification as investment property:

Exeter House	This property does not fall within the definition of investment property in accordance with IAS 40, as it is owner occupied. It should be accounted for as property, plant and equipment under IAS 16.
33–39 Reeves Road	Although this property is not legally owned, it is held as a right-of-use asset in accordance with IFRS 16, *Leases*, and can be treated as an investment property from the date of renting out to a third party.
41–51 Reeves Road	Although vacant it can be classified as an investment property as it is held for investment purposes.

Falcon House	This property is owned by Mayflower and the vast majority of it is let out to third parties. It appears unlikely that the two parts of the property (that rented to a third party and that used by Mayflower) could be sold or leased separately, particularly the part used by Mayflower, as it is a couple of small rooms in the basement. It is therefore inappropriate to treat the two parts separately as investment property and property, plant and equipment respectively. As the part used by Mayflower appears to be an insignificant portion of the whole, the whole property can be treated as an investment property.

Valuation

Exeter House	This should be valued according to IAS 16 (at cost or revalued amount less depreciation).
33–39 Reeves Road	This should have been recognised at the inception of the lease at the present value of the future lease payments. On being rented out it would be valued at fair value in accordance with company policy in respect of investment properties. The revaluation to fair value on transfer to investment properties is accounted for under IAS 16. Thereafter changes in fair value are recognised in profit or loss.
41–51 Reeves Road	This should be initially recognised at cost, including transaction costs. As the fair value model is being adopted the asset should be subsequently recognised at fair value. Changes in fair value are recognised in profit or loss.
Falcon House	Recognised at fair value, changes in fair value are recognised in profit or loss, as above.

IAS 40 requires that the fair value of the investment properties should be measured in accordance with IFRS 13.

Audit procedures

- Confirm that all investment properties are classified in accordance with IAS 40 definitions (see above).
- Ensure that Exeter House is reclassified as property, plant and equipment.
- Assess useful life of Exeter House and residual value in order to recalculate and agree depreciation charged.
- Determine the valuation policy to be used for Exeter House ie, cost or valuation and ensure that the policy is correctly applied.
- Evaluate the process by which Mayflower establishes fair values of investment properties and the control environment around such procedures.
- Determine basis for calculation of fair values (per IAS 40 (40) fair value must reflect rental income from current leases and other assumptions that market participants would use when pricing investment property under current market conditions). Look for best evidence of fair value (for example, year-end prices in an active market for similar properties in the same location and condition).
- If external valuers have been used agree valuation to valuer's certificate and assess the extent that they can be relied on in accordance with ISA 620.

- If fair values have been based on discounted cash flows, ie, future rentals, determine whether this is the most appropriate estimate of a market-based exit value. Compare predicted cash flows with rental agreements. Review the basis of the interest rate applied.
- Review documentation to support method used.
- Recalculate the gain or loss on change in fair value and agree to amount recognised in profit or loss.
- If fair value cannot be measured reliably confirm use of cost model.
- Agree disclosure is in accordance with IAS 40 and IFRS 13.

Chapter 20

Groups: types of investment and business combination

Introduction

Learning outcomes

Chapter study guidance

Learning topics

Introduction

Learning outcomes

- Appraise and evaluate cash flow measures and disclosures in single entities and groups
- Analyse and evaluate the criteria used to determine whether and how different types of investment are recognised and measured as business combinations
- Calculate and produce, from financial and other data, the amounts to be included in an entity's consolidated financial statements in respect of its new, continuing and discontinued interests (which include situations when acquisitions occur in stages and in partial disposals) in subsidiaries, associates and joint ventures
- Justify and conclude for a particular scenario what comprises sufficient, appropriate audit evidence
- Design and determine audit procedures in a range of circumstances and scenarios, for example identifying an appropriate mix of tests of controls, analytical procedures and tests of details
- Demonstrate and explain, in the application of audit procedures, how relevant ISAs affect audit risk and the evaluation of audit evidence

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
1	**Summary and categorisation of investments** In a working context you will have to account for acquisitions, disposals and business combinations such as investments in associates, joint arrangements, or consolidations of subsidiaries.	**Approach** This chapter is revision from your studies at Professional Level. This introductory section starts with a useful summary table showing which standard to apply. **Stop and think** Can a 45% investment be a subsidiary?	Exam questions will be more complex than at Professional Level and you will need to exercise judgement more.	N/A
2	**IFRS 10, *Consolidated Financial Statements*** IFRS 10 will be familiar to you, but you should still	**Approach** The key to this section is **control.** Study the definition carefully, and make sure you understand	You may well have to determine the status of an investment by applying the definition of control.	N/A While there are no interactive questions in this section, you can test yourself by covering up the

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
	approach this section as if you are studying it from scratch, because it is so fundamental to have a grasp of the brought forward knowledge.	power, returns and the link between power and returns. Then read through the sections on exemption, exclusion and uniform accounting policies. **Stop and think** Why would uniform accounting policies be preferable?		solution to the worked example which tests some rather complex aspects of control that you won't have met at earlier levels.
3	**IFRS 3, *Business Combinations*** Again this should be revision, but bear in mind that the level required is A rather than B, as before.	**Approach** Focus on the four-stage process in using the acquisition method: • Identify acquirer • Acquisition date • Recognise and measure assets • Recognise and measure goodwill (see worked examples) **Stop and think** What is a control premium?	At Advanced Level, the acquirer may not always be easy to identify.	**IQ1: Calculation of goodwill** This question focuses on the consideration aspect of the goodwill calculation. You should do both interactive questions in this section.
4	**IFRS 13, *Fair Value Measurement* (business combination aspects)** You have met IFRS 13 in many contexts, including investment property and financial instruments. This section focuses on the business combination issues, relating to valuing the assets and liabilities for the	**Approach** Recap the IFRS 13 rules on fair value, including the hierarchy. Then study the worked example carefully. **Stop and think** How is a decommissioning liability valued in a business combination?	At Advanced Level the valuation of the assets and liabilities in a business combination may not be straightforward.	**IQ3: Goodwill on consolidation** This focuses on the assets and liabilities, the other main part of the goodwill calculation.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
	purposes of calculating goodwill.			
5	**IAS 28, *Investments in Associates and Joint Ventures*** Associates and joint ventures are both accounted for using the equity method.	**Approach** Make sure you know how the equity method is applied in the statement of financial position, the statement of profit or loss and in other comprehensive income. **Stop and think** What is the double entry for when an associate sells to the parent?	As well as being comfortable with equity accounting, you may come across associates in a step acquisition (associate to subsidiary) or disposal (subsidiary to associate), so you need to be clear about what is meant by significant influence. Joint ventures have been tested regularly, sometimes in an audit context or where the investment has been wrongly treated as a joint operation.	N/A While there are no interactive questions in this section, you can test yourself by covering up the solution to the worked example.
6	**IFRS 11, *Joint Arrangements*** Business combinations are becoming increasingly complex. The nature of purchase consideration and the legal form of such transactions are often driven by financial and tax features. Structures are carefully modelled to ensure that transactions optimise post-acquisition earnings as well as meeting corporate strategic objectives.	**Approach** Make sure you understand the distinction between joint ventures (equity accounted) and joint operations (line by line recognition of assets, liabilities, revenue and expenses). **Stop and think** How is a joint arrangement different from an associate?	Joint ventures are examined much more frequently than joint operations.	**IQ4: Joint arrangement** This question asks why joint operations are formed.
7	**Question technique and practice**	**Approach** Learn the step-by-	In the exam you will need to know all the techniques used in	**IQ6: Consolidation technique 2**

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
	This is an essential section – the brought forward knowledge should be second nature.	step process in sections 7.1 and 7.2. Then do both interactive questions. **Stop and think** Did you get them at least 80% right? If not, practise using the self-test questions at the beginning of the Chapter.	this section, but the consolidation will only be one of the complexities you will be facing.	You should really do both interactive questions, but if you're going to pick one, pick this one as it is more substantial than IQ5: Consolidation technique 1.
8	**IFRS 12, *Disclosure of Interests in Other Entities*** Users should review the disclosures included in the financial statements regarding business combinations. Extensive disclosures allow users of the financial statements to understand the effect of the combination on the group's operations during the period. This improves the predictive value of the financial information.	**Approach** Read through and highlight. **Stop and think** Extensive disclosures allow users of the financial statements to understand the effect of the combination on the group's operations during the period. This improves the predictive value of the financial information.	IFRS 12 has not been examined yet. It is more likely to come up in an auditing context.	N/A There are no interactive questions on this short section.
9	**Step acquisitions** This topic is new to Advanced Level, and happens quite a lot in practice.	**Approach** The key question is: has an accounting boundary been crossed? Whenever you cross the 50% boundary, you revalue, and a gain or loss is reported in profit or loss for the year. If you do not cross the 50% boundary, no	Step acquisitions are regularly tested, so it is important to get a good grasp of the technique in this section.	**IQ7: Control in stages – no previous significant influence** You don't have to prepare the consolidated financial statements in this question, but you do have to do the significant calculations relating to step acquisitions that will enable you to prepare them.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
		gain or loss is reported; instead there is an adjustment to the parent's equity. **Stop and think** If you go from 60% to 80%, an accounting boundary is not crossed. If you go from 40% to 80% it is.		
10	**Disposals** While you have met disposals at Professional Level, you will not have come across partial disposals.	**Approach** As with step acquisitions, the key question is, was an accounting boundary crossed? **Stop and think** If you go from 80% to 60%, an accounting boundary is not crossed. If you go from 80% to 40% it is.	Partial disposals (subsidiary to associate or investments) are more likely to be tested at Advanced Level because complete disposals were tested at Professional Level.	**IQ8: All types of disposal** This covers 100% disposal, partial disposal without losing control, partial disposal to associate, control lost and partial disposal to asset at FVTOCI with control lost.
11	**Consolidated statements of cash flows** You may also be required to prepare consolidated statements of cash flows, which are likely to include the effect of acquisitions and disposals.	**Approach** You have already revised single company statements of cash flows, so focus on the aspects specific to groups: acquisition or disposal of an associate or subsidiary during the period. **Stop and think** When taking account of the disposal in calculating working capital movements, make sure you get the pluses and	Because single company statements of cash flow were examined at Professional Level, you are more likely to get a consolidated statement at Advanced Level.	**IQ10: Disposal** This question focuses on every calculation related to the group aspects, even though you don't need to prepare the statement itself.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
		minuses the right way round.		
12	**Audit focus: group audits** This is a long chapter, but do not neglect section 12, which deals with group audits, including foreign subsidiaries. You may wish to come back to that part once you have studied foreign currency transactions.	**Approach** Focus on sections 12.6 and 12.7 on group audit procedures. **Stop and think** What are component auditors?	You may well get a scenario where an overseas subsidiary company has been acquired during the year, audited by another firm overseas which raises technical audit issues regarding the audit approach and the application of ISA UK 600 (Revised November 2019).	**IQ11: Component auditors** This is a comprehensive question on a key issue in the audit of group financial statements.
13	**Auditing global enterprises** This section focuses on risk, which is generally greater when auditing a foreign company.	**Approach** Focus on the table in section 13.3. **Stop and think** Why is transfer pricing so difficult?	Risk is always important in auditing questions.	N/A

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Summary and categorisation of investments

Section overview

- This chapter revises IFRS 3, *Business Combinations*, which was covered at Professional Level. It also covers the following standards:
  - IFRS 13, *Fair Value Measurement* (business combination aspects)
  - IFRS 10, *Consolidated Financial Statements*
  - IAS 28, *Investments in Associates and Joint Ventures*
  - IFRS 11, *Joint Arrangements*
  - IFRS 12, *Disclosure of Interests in Other Entities*
- Some of the above IFRS® Standards, or the topics to which they relate, were covered at Professional Level, but a deeper knowledge is needed at Advanced Level.

A summary of the different types of investment and the required accounting for them is as follows.

Investment	Criteria	Required treatment in group accounts
Subsidiary	Control	Full consolidation (IFRS 10)
Associate	Significant influence	Equity accounting (IAS 28)
Joint venture	Contractual arrangement	Equity accounting (IAS 28), distinguish from joint operation (IFRS 11)
Investment which is none of the above	Asset held for accretion of wealth	As for single company accounts (per IFRS 9)

1.1 Investments in subsidiaries

The important point here is **control**. In most cases, this will involve the parent company owning a majority of the ordinary shares in the subsidiary (to which normal voting rights are attached). There are circumstances, however, when the parent may own only a minority of the voting power in the subsidiary, **but** the parent still has control.

IFRS 10, *Consolidated Financial Statements* has **control** as the key concept underlying the parent/subsidiary relationship but it has broadened the definition and clarified its application. This will be covered in more detail in section 2 below.

IFRS 10 states that an investor **controls** an investee if and only if it has all of the following.

(a) **Power** over the investee

(b) Exposure, or rights, to **variable returns** from its involvement with the investee (see section 2)

(c) The **ability to use its power** over the investee to affect the amount of the investor's returns (see section 2)

1.2 Investments in associates

The key criterion here is **significant influence**. This is defined as the 'power to participate', but **not** to 'control' (which would make the investment a subsidiary).

Significant influence is presumed to exist if an investor holds **20% or more of the voting power** of the investee, **unless** it can be clearly shown that this is not the case.

However, the **existence of significant influence** can also be evidenced in other ways.

- Representation on the **board of directors** of the investee
- Participation in the **policy making process**
- **Material transactions** between investor and investee
- Interchange of **management personnel**
- Provision of **essential technical information**

IAS 28, *Investments in Associates and Joint Ventures* requires the use of the **equity method** of accounting for investments in associates. This method will be explained in section 5.

1.3 Accounting for investments in joint arrangements

IFRS 11 classes joint arrangements as either **joint operations** or **joint ventures**. The classification of a joint arrangement as a joint operation or a joint venture depends on the rights and obligations of the parties to the arrangement.

The detail of how to distinguish between joint operations and joint ventures will be considered in section 6.

1.3.1 Accounting treatment in group accounts

IFRS 11 requires that a joint operator recognises line by line the following in relation to its interest in a **joint operation**:

- Its (the joint operation's) assets, including its (the investor's) share of any jointly held assets
- Its liabilities, including its share of any jointly incurred liabilities
- Its revenue from the sale of its share of the output arising from the joint operation
- Its share of the revenue from the sale of the output by the joint operation
- Its expenses, including its share of any expenses incurred jointly

This treatment is applicable in both the separate and consolidated financial statements of the joint operator.

In its consolidated financial statements, IFRS 11 requires that a joint venturer recognises its interest in a **joint venture** as an investment and accounts for that investment using the equity method in accordance with IAS 28, *Investments in Associates and Joint Ventures* unless the entity is exempted from applying the equity method (see section 5).

In its separate financial statements, a joint venturer should account for its interest in a joint venture in accordance with IAS 27, *Separate Financial Statements,* namely:

- at cost;
- in accordance with IFRS 9, *Financial Instruments*; or
- using the equity method specified in IAS 28.

1.4 Other investments

Investments which do not meet the definitions of any of the above should be accounted for according to IFRS 9, *Financial Instruments.* An example of such an investment would be a 15% shareholding in a company with no significant influence.

2 IFRS 10, *Consolidated Financial Statements*

Section overview

IFRS 10 covers the basic definitions and consolidation requirements and the rules on **exemptions** from preparing group accounts. The standard requires a parent to **present consolidated financial statements**, consolidating **all subsidiaries**, both foreign and domestic. The most important aspect is **control**.

2.1 Introduction

When a parent issues consolidated financial statements, it should consolidate **all subsidiaries**, both foreign and domestic. The first step in any consolidation is to identify the subsidiaries present in the group.

Definition

Consolidated financial statements: The financial statements of a group presented as those of a single economic entity. (IFRS 10)

You should make sure that you understand the various ways in which **control** can arise, as this is something that you may be asked to discuss in the context of a scenario in the exam.

2.1.1 Power

Power is defined as **existing rights that give the current ability to direct the relevant activities of the investee**. There is no requirement for that power to have been exercised.

Relevant activities may include:

- selling and purchasing goods or services
- managing financial assets
- selecting, acquiring and disposing of assets
- researching and developing new products and processes
- determining a funding structure or obtaining funding

In some cases assessing power is straightforward; for example, where power is obtained directly and solely from having the majority of voting rights or potential voting rights, and as a result the ability to direct relevant activities.

In other cases, assessment is more complex and more than one factor must be considered. IFRS 10 gives the following examples of **rights**, other than voting or potential voting rights, which individually, or alone, can give an investor power.

- Rights to appoint, reassign or remove key management personnel who can direct the relevant activities
- Rights to appoint or remove another entity that directs the relevant activities
- Rights to direct the investee to enter into, or veto changes to, transactions for the benefit of the investor
- Other rights, such as those specified in a management contract

Voting rights **in combination with other rights** may give an investor the current ability to direct the relevant activities. For example, this is likely to be the case when an investor holds 40% of the voting rights of an investee and holds substantive rights arising from options to acquire a further 20% of the voting rights.

IFRS 10 suggests that the **ability** rather than contractual right to achieve the above may also indicate that an investor has power over an investee.

An investor can have power over an investee even where other entities have significant influence or other ability to participate in the direction of relevant activities.

2.1.2 Returns

An investor must have exposure, or rights, to **variable returns** from its involvement with the investee in order to establish control.

This is the case where the investor's returns from its involvement have the potential to vary as a result of the investee's performance.

Returns may include the following:

- Dividends
- Remuneration for servicing an investee's assets or liabilities
- Fees and exposure to loss from providing credit support
- Returns as a result of achieving synergies or economies of scale through an investor combining use of their assets with use of the investee's assets

2.1.3 Link between power and returns

In order to establish control, an investor must be able to use its power to affect its returns from its involvement with the investee. This is the case even where the investor delegates its decision-making powers to an agent.

Professional skills focus: Structuring problems and solutions

When determining whether an entity has control, it often helps to draw a group structure diagram, which helps clarify what is going on. Such a diagram is also useful, together with a timeline, in questions involving mid-year acquisitions or disposals.

Worked example: Control

1. Twist holds 40% of the voting rights of Oliver and 12 other investors each hold 5% of the voting rights of Oliver. A shareholder agreement grants Twist the right to appoint, remove and set the remuneration of management responsible for directing the relevant activities. To change the agreement, a two-thirds majority vote of the shareholders is required. To date, Twist has not exercised its rights with regard to the management or activities of Oliver.

   Requirement

   Explain whether Twist should consolidate Oliver in accordance with IFRS 10.

2. Copperfield holds 45% of the voting rights of Spenlow. Murdstone and Steerforth each hold 26% of the voting rights of Spenlow. The remaining voting rights are held by three other shareholders, each holding 1%. There are no other arrangements that affect decision making.

   Requirement

   Explain whether Copperfield should consolidate Spenlow in accordance with IFRS 10.

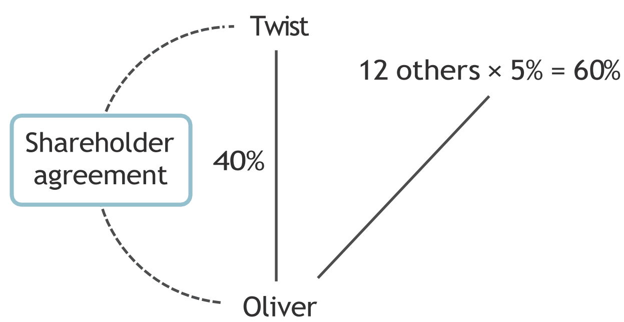
3. Scrooge holds 70% of the voting rights of Cratchett. Marley has 30% of the voting rights of Cratchett. Marley also has an option to acquire half of Scrooge's voting rights, which is exercisable for the next two years, but at a fixed price that is deeply out of the money (and is expected to remain so for that two-year period).

Requirement

Explain whether either of Scrooge or Marley should consolidate Cratchett in accordance with IFRS 10.

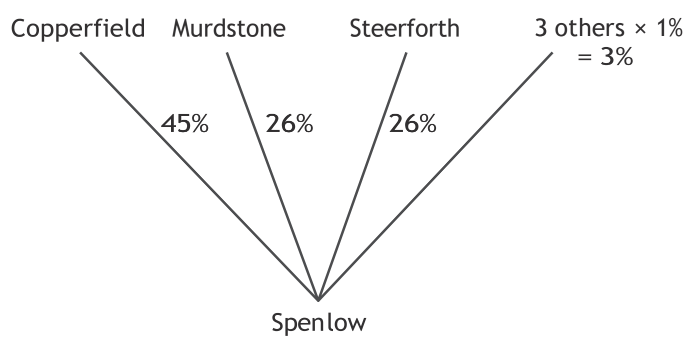
Solution

1 **Group structure 1**



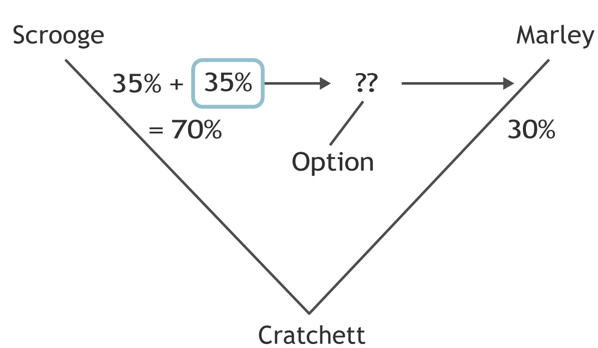
The absolute size of Twist's holding and the relative size of the other shareholdings alone are not conclusive in determining whether the investor has rights sufficient to give it power. However, the fact that Twist has **a contractual right to appoint, remove and set the remuneration of management** is sufficient to conclude that it **has power over Oliver**. The fact that Twist has not exercised this right is not a determining factor when assessing whether Twist has power. In conclusion, Twist does control Oliver, and should consolidate it.

2 **Group structure 2**



In this case, the size of Copperfield's voting interest and its size relative to the other shareholdings are sufficient to conclude that Copperfield **does not have power**. Only two other investors, Murdstone and Steerforth, would need to cooperate to be able to prevent Copperfield from directing the relevant activities of Spenlow.

3 **Group structure 3**



Scrooge holds a majority of the current voting rights of Cratchett, so is likely to meet the power criterion because it appears to have the current ability to direct the relevant activities. Although Marley has currently exercisable options to purchase additional voting rights (that, if exercised, would give it a majority of the voting rights in Cratchett), the terms and conditions associated with those options are such that the options are not considered substantive.

Thus voting rights, even combined with potential voting rights, may not be the deciding factor. Scrooge should consolidate Cratchett.

2.2 Exemption from preparing group accounts

A parent **need not present** consolidated financial statements if and only if all of the following hold:

(a) The parent is itself a **wholly owned subsidiary** or it is a **partially owned subsidiary** of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements.

(b) Its debt or equity instruments are **not publicly traded**.

(c) It is **not in the process of issuing securities** in public securities markets.

(d) The **ultimate or intermediate parent** publishes consolidated financial statements that comply with International Financial Reporting Standards.

A parent that does not present consolidated financial statements must comply with the IAS 27 rules on separate financial statements.

Although a parent may not have to prepare consolidated financial statements, it may wish to provide qualitative information about the nature and size of ownership of un-consolidated subsidiaries as this could be beneficial to the users of the financial statements.

2.3 Potential voting rights

An entity may own share warrants, share call options or other similar instruments that are **convertible into ordinary shares** in another entity. If these are exercised or converted they may give the entity voting power or reduce another party's voting power over the financial and operating policies of the other entity (potential voting rights). The **existence and effect** of potential voting rights, including potential voting rights held by another entity, should be considered when assessing whether an entity has control over another entity (and therefore has a subsidiary). Potential voting rights are considered only if the rights are **substantive** (meaning that the holder must have the practical ability to exercise the right).

In assessing whether potential voting rights give rise to control, the investor should consider the **purpose and design of the instrument**. This includes an assessment of the various terms and conditions of the instrument as well as the investor's apparent expectations, motives and reasons for agreeing to those terms and conditions.

2.4 Exclusion of a subsidiary from consolidation

Where a parent controls one or more subsidiaries, IFRS 10 requires that consolidated financial statements are prepared to include **all subsidiaries, both foreign and domestic**, other than:

- those held for sale in accordance with IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*; and
- those held under such long-term restrictions that control cannot be operated.

The rules on exclusion of subsidiaries from consolidation are necessarily strict, because this is a common method used by entities to manipulate their results. If a subsidiary which carries a large amount of debt can be excluded, then the gearing of the group as a whole will be improved. In other words, this is a way of taking debt **out of the consolidated statement of financial position**.

IFRS 10 is clear that a subsidiary should not be excluded from consolidation simply because it is loss making or its business activities are dissimilar from those of the group as a whole. IFRS 10 rejects the latter argument: exclusion on these grounds is not justified because better information can be provided about such subsidiaries by consolidating their results and then giving additional information about the different business activities of the subsidiary, eg, under IFRS 8, *Operating Segments*.

2.5 Other matters

Different reporting dates

Where one or more subsidiaries prepare accounts to a different reporting date from the parent and the bulk of other subsidiaries in the group:

(a) the subsidiary may prepare additional statements to the reporting date of the rest of the group, for consolidation purposes; or

(b) if this is not possible, the subsidiary's accounts may still be used for consolidation **provided that** the gap between the reporting dates is **three months or less** and that **adjustments are made** for the effects of significant transactions or other events that occur between that date and the parent's reporting date.

Uniform accounting policies

Uniform **accounting policies** should be used and **adjustments** must be made where the subsidiary's policies differ from those of the parent.

Date of inclusion/exclusion

The results of subsidiary undertakings are included in the consolidated financial statements from:

(a) the date of 'acquisition' ie, the **date on which the investor obtains control**; to

(b) the date of 'disposal' ie, the **date when the investor loses control**.

Once an investment is no longer a subsidiary, it should be treated as an associate under IAS 28 (if applicable) or as an investment under IFRS 9.

Accounting for subsidiaries and associates in the parent's separate financial statements

A parent company will usually produce its own single company financial statements. In these statements, governed by IAS 27, *Separate Financial Statements,* investments in subsidiaries and associates included in the consolidated financial statements should be **either**:

- accounted for at **cost**;
- in accordance with **IFRS 9**; or
- using the equity method specified in IAS 28.

Where subsidiaries are **classified as held for sale** in accordance with IFRS 5 they should be accounted for in accordance with IFRS 5.

Non-controlling interest (NCI)

Within the statement of profit or loss and other comprehensive income, profit for the year and total comprehensive income must be split between the shareholders of the parent and the non- controlling interest.

IFRS 10 requires an entity to attribute their share of total comprehensive income to the non-controlling interest, even if this results in a negative (debit) NCI balance.

Acquisitions and disposals which do not result in a change of control

Acquisitions of further shares in an existing subsidiary or disposals of shares by a parent which do not result in a loss of control are accounted for within shareholders' equity.

No gain or loss is recognised and goodwill is not remeasured. This is explained further within sections 9 and 10 of this chapter.

Loss of control

Where a parent loses control of a subsidiary:

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

This is explained further within section 10 of this chapter.

3 IFRS 3, *Business Combinations*

Section overview

- IFRS 3 refers to business combinations as 'transactions or events in which an **acquirer** obtains control of one or more **businesses**'. In a straightforward business combination one entity acquires another, resulting in a parent/subsidiary relationship.
- Business combinations are accounted for using the **acquisition method**.

3.1 The acquisition method

All business combinations should be recognised using the **acquisition** method which involves the following steps.

(a) **Identifying an acquirer** – which obtains **control** of the other entity. If this cannot be established from shareholdings and other factors listed in IFRS 10 (see section 2.1 above), IFRS 3 provides additional indicators, such as the fact that the entity **with the larger fair value** is likely to be the acquirer.

(b) **Determining the acquisition date**. This is generally the date on which the parent company (acquirer) transfers consideration and acquires the net assets of the acquiree.

(c) **Recognising and measuring** the **identifiable assets** acquired, the **liabilities** assumed and any **non-controlling interest** in the acquiree.

(d) **Recognising and measuring goodwill** or a **gain from a bargain purchase**.

Measurement of the non-controlling interest in Step 3 along with the measurement of goodwill in Step 4 are covered in more detail in the next section.

Measurement of the identifiable assets and liabilities in Step 3 is covered in section 3.6 of this chapter.

3.2 Calculation of goodwill

IFRS 3 (Revised) requires goodwill acquired in a business combination (or a gain on a bargain purchase) to be measured as:

	£
Consideration transferred: Fair value of assets given, liabilities assumed and equity instruments issued, including contingent amounts	X
Non-controlling interest at the acquisition date	X
	X
Less total fair value of net assets of acquiree	(X)
Goodwill/(gain from a bargain purchase)	X/(X)

This calculation includes the non-controlling interest and is therefore calculated based on the whole net assets of the acquiree.

Sections 3.3 and 3.4 consider the first two elements of the revised calculation – consideration transferred and the non-controlling interest – in more detail.

Worked example: Calculation of goodwill 1

On 1 January 20X7, Avon acquired 80% of the equity share capital of Tweed, for a total consideration of £670,000. The fair value of the net assets of Tweed at this date was £700,000. The non-controlling interest is measured at £140,000.

Requirement

What goodwill arises on the acquisition?

Solution

Goodwill is calculated as:

	£
Consideration transferred	670,000
Non-controlling interest at the acquisition date	140,000
	810,000
Less total fair value of net assets of acquiree	(700,000)
Goodwill	110,000

In this example the non-controlling interest has been measured as the relevant percentage of Tweed's acquisition date net assets ie, 20% × £700,000.

Note that the non-controlling interest is not necessarily calculated as a proportion of acquisition date net assets.

3.3 Consideration transferred

Contingent consideration – initial measurement

IFRS 3 requires the consideration to be measured at the fair value at the acquisition date. This includes any contingent consideration payable even if, at the date of acquisition, **it is not deemed probable** that it will be paid.

Contingent consideration – subsequent measurement

IFRS 3 requires contingent consideration to be classified as follows:

- A liability where contingent consideration is cash or shares to a specific value

- Equity where contingent consideration is a specified number of ordinary shares regardless of their value

Subsequent changes are then dealt with as follows:

(a) If the change is due to additional information obtained that affects the position at the acquisition date, goodwill should be remeasured.

(b) If the change is due to events which took place after the acquisition date, for example, meeting earnings targets:

    (1) where consideration is recorded as a liability (including a provision), any remeasurement is recorded in profit or loss (so an increase in the liability due to strong performance of the subsidiary will result in an expense and a decrease in the liability due to underperformance will result in a gain); and

    (2) where consideration is recorded in equity, remeasurement is not required.

The treatment means that group profits are now reduced where good performance of the subsidiary results in additional payments to the seller.

Acquisition-related costs

These costs do not form part of consideration within the above calculation. Instead, all finders' fees, legal, accounting, valuation and other professional fees must be expensed through profit or loss.

Costs incurred to issue securities will be dealt with in accordance with IFRS 9. The treatment will therefore reduce goodwill values and profits.

3.4 Non-controlling interest

The standard allows a **choice** in valuing the non-controlling interest within the goodwill calculation. It may be measured either:

- as a proportion of the identifiable net assets of the subsidiary at the acquisition date (as in the example above); or
- at fair value of the equity shares held by the non-controlling interest on the acquisition date.

The choice is available on a transaction by transaction basis.

The **proportion of net assets** method is used to value the non-controlling interest (NCI) at the reporting date. It requires identifiable assets to be recognised at the fair values of the individual assets. Where this method is used to value the non-controlling interest under IFRS 3 (Revised), the resulting goodwill corresponds only to the share of the entity held by the parent company.

The **fair value** method brings measurement of the non-controlling interest into line with measurement of consideration and the acquiree's net assets (ie, all at fair value). The fair value of the non-controlling interest (eg, the active market prices of the equity shares not held by the acquirer) is likely to exceed the proportion of net assets attributable to the non-controlling interest, this being by an amount which represents goodwill attributable to the non-controlling interest. Therefore goodwill on acquisition calculated using this method will represent 100% of goodwill in the acquiree.
Accordingly, this method is sometimes known as the '**full goodwill**' method.

Worked example: Calculation of goodwill 2

The consideration transferred by National plc when it acquired 80,000 of the 100,000 equity shares of Locale Ltd was £25 million. At the acquisition date the fair value of Locale Ltd's net assets was £21 million and the fair value of the 20,000 equity shares in Locale Ltd not acquired was £5 million.

Requirement

Calculate the goodwill acquired in the business combination on the basis that the non-controlling interest in Locale Ltd is measured at:

(1) Its share of identifiable net assets

(2) Fair value of the non-controlling interest's equity shares

Solution

Goodwill

	(1) NCI at share of net assets £'000	(2) NCI at fair value £'000
Consideration transferred	25,000	25,000
Non-controlling interest – 20% × £21m/fair value	4,200	5,000
	29,200	30,000
Total net assets of acquiree	(21,000)	(21,000)
Goodwill acquired in business combination	8,200	9,000

As the non-controlling interest is £0.8 million higher when measured at fair value, it follows that goodwill is also £0.8 million higher.

This amount is the goodwill relating to the non-controlling interest. The calculation of goodwill when the NCI is valued at fair value could be laid out as:

	Group £'000	NCI £'000
Consideration/fair value	25,000	5,000
Share of net assets 80%/20% × £21m	(16,800)	(4,200)
Goodwill	8,200	800

Total (or full) goodwill is £9 million; of this, the parent's share is £8.2 million and the non-controlling interest's share is £0.8 million.

Note that the goodwill is not split in the same proportion as ownership of the shares:

- National owns 80% of the shares but 91% of goodwill.
- The non-controlling interest owns 20% of shares but just 9% of goodwill.

This discrepancy is due to the 'control premium' paid by National.

Interactive question 1: Calculation of goodwill

On 1 January 20X5, ABC acquired 90% of DEF when the fair value of DEF's net assets was £18 million. The consideration was structured as follows.

- Three million ABC ordinary shares to be issued on the acquisition date.
- An additional one million ABC ordinary shares to be issued on 31 December 20X6 if DEF's revenue increases by 10% in the interim two years. This condition is likely to be achieved.

The market price of ABC ordinary shares is £7 at the acquisition date and has increased to £9 by 31 December 20X6.

ABC incurs professional acquisition fees amounting to £50,000.

It is ABC group policy to value the non-controlling interest using the proportion of net assets method.

Requirement

Calculate the consideration transferred and the goodwill arising on acquisition.

See **Answer** at the end of this chapter.

3.4.1 Non-controlling interest – subsequent valuation

Where the non-controlling interest is measured using the proportion of net assets method, the NCI at the reporting date is calculated as the non-controlling interest's share of the subsidiary's net assets.

Where the non-controlling interest is measured using the fair value method, a consolidation adjustment is required to recognise the additional goodwill in the consolidated statement of financial position. This is best achieved using the following calculation:

Non-controlling interest

	£	£
Share of net assets (NCI% × net assets at reporting date (W2))		X
Share of goodwill		
NCI at acquisition date at fair value (W3)	X	
NCI at acquisition date at share of net assets (NCI% × net assets at acquisition (W2))	(X)	
Difference, being goodwill attributable to NCI		X
		X

Note: The references are to standard consolidation workings: W2 Net assets of the subsidiary W3 Goodwill working

Interactive question 2: Non-controlling interest

Robson acquired 75% of the ordinary shares of Ives on 30 June 20X7. At this date Ives had net assets of £250,000, and the fair value of the 25% of Ives's equity shares not acquired by Robson was £90,000. Ives uses the fair value (full goodwill) method to measure non-controlling interests. The abbreviated statement of financial position of Ives at 31 December 20X9 is as follows:

	£
Assets	440,000
Share capital	100,000
Retained earnings	245,000
Liabilities	95,000
	440,000

- At acquisition, the fair value of land owned by Ives was £50,000 greater than its carrying amount; Ives has subsequently sold the land to a third party.

- During the year ended 31 December 20X9, Ives sold goods to Robson, making a profit of £12,000. Half of these goods are included in Robson's inventory count at the year end.

Requirement

What is the value of the non-controlling interest in the consolidated statement of financial position at 31 December 20X9?

See **Answer** at the end of this chapter.

3.5 Step acquisitions

Under IFRS 3 and IFRS 10, acquisition accounting is only applied to business combinations when control is achieved.

Where a parent acquires control of a subsidiary in stages (a step acquisition), this means that goodwill is only calculated once, upon initially achieving control. It is not then recalculated in response to further acquisitions of shares in the same subsidiary.

Accounting for step acquisitions is covered in further detail within section 9 of this chapter.

3.6 Assets and liabilities acquired

In the previous sections, we discussed the first two elements of the goodwill calculation: consideration transferred and the non-controlling interest.

This section deals with the third element of goodwill – the net assets acquired.

3.6.1 Recognition

Assets and liabilities existing at the acquisition date, and meeting the *Conceptual Framework* definition of an asset or liability, should be recognised within the goodwill calculation.

(a) Only those liabilities which **exist at the date of acquisition** are recognised (so not future operating losses or reorganisation plans which will be put into effect after control is gained).

(b) Some assets not recognised by the acquiree in its individual company financial statements may be recognised by the acquirer in the consolidated financial statements. These include identifiable intangible assets, such as brand names. Identifiable means that these assets are separable or arise from contractual or other legal rights.

3.6.2 Measurement

The basic requirement of IFRS 3 is that the identifiable assets and liabilities acquired are measured at their acquisition date **fair value.**

To understand the importance of fair values in the acquisition of a subsidiary, consider again the definition of goodwill.

Definition

Goodwill: Any excess of the cost of the acquisition over the acquirer's interest in the fair value of the identifiable assets and liabilities acquired as at the date of the exchange transaction.

The **statement of financial position of a subsidiary company** at the date it is acquired may not be a guide to the fair value of its net assets. For example, the market value of a freehold building may have risen greatly since it was acquired, but it may appear in the statement of financial position at historical cost less accumulated depreciation.

3.6.3 What is fair value?

Fair value is defined as follows by IFRS 13, *Fair Value Measurement* – it is an important definition.

"The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." (IFRS 13, Appendix A)

We will look at the requirements of IFRS 3 and IFRS 13 regarding fair value in more detail in section 4. First, let us look at some practical matters. The following example will remind you how to make a fair value adjustment, using the standard consolidation workings from your Professional Level studies.

Worked example: Fair value adjustment

P Co acquired 75% of the ordinary shares of S Co on 1 September 20X5. At that date the fair value of S Co's non-current assets was £23,000 greater than their carrying amount, and the balance of retained earnings was £21,000. The fair value of the non-controlling interest was £17,000. The statements of financial position of both companies at 31 August 20X6 are given below. S Co has not incorporated any revaluation in its financial statements.

P Co values the non-controlling interest using the fair value (full goodwill) method.

P Co statement of financial position as at 31 August 20X6

	£	£
Assets		
Non-current assets		
Tangible assets	63,000	
Investment in S Co at cost	51,000	
		114,000
Current assets		82,000
Total assets		196,000
Equity and liabilities		
Equity		
Ordinary shares of £1 each	80,000	
Retained earnings	96,000	
		176,000
Current liabilities		20,000
Total equity and liabilities		196,000

S Co statement of financial position as at 31 August 20X6

	£	£
Assets		
Tangible non-current assets		28,000
Current assets		43,000
Total assets		71,000
Equity and liabilities		
Equity		
Ordinary shares of £1 each	20,000	
Retained earnings	41,000	
		61,000
Current liabilities		10,000
Total equity and liabilities		71,000

If S Co had revalued its non-current assets at 1 September 20X5, an addition of £3,000 would have been made to the depreciation expense charged for 20X5/X6.

Requirement

Prepare P Co's consolidated statement of financial position as at 31 August 20X6.

Solution

P Co consolidated statement of financial position as at 31 August 20X6

	£	£
Assets		
Non-current assets		
Tangible non-current assets £(63,000 + 28,000 + 23,000 – 3,000)	111,000	
Intangibles – goodwill (W3)	4,000	
		115,000
Current assets £(82,000 + 43,000)		125,000
Total assets		240,000
Equity and liabilities		
Capital and reserves Ordinary share capital	80,000	
Retained earnings (W5)	108,750	
Equity		188,750
Non-controlling interest (W4)		21,250
		210,000
Current liabilities £(20,000 + 10,000)		30,000
Total equity and liabilities		240,000

WORKINGS

(1) **Group structure**

P Co

↓ 75%

S Co

(2) **Net assets**

	Reporting date	Acquisition	Post -acquisition
	£	£	£
Share capital	20,000	20,000	–
Retained earnings			
– per question	41,000	21,000	20,000
– additional depreciation	(3,000)		(3,000)
Fair value adjustment to PPE	23,000	23,000	
	81,000	64,000	17,000

(3) **Goodwill**

	£
Consideration transferred	51,000
Non-controlling interest	17,000
	68,000
Less net assets of acquiree (W2)	(64,000)
	4,000

(4) **Non-controlling interest**

	£	£
S Co (25% × £81,000 (W2))		20,250
NCI share of goodwill at acquisition		
FV of NCI at acquisition	17,000	
NCI share of net assets at acquisition (25% × £64,000)	(16,000)	
		1,000
Non-controlling interest		21,250

(5) **Retained earnings**

	£
P Co	96,000
S Co (£17,000 (W2) × 75%)	12,750
	108,750

Remember also that when preparing consolidated financial statements all **intra-group balances, transactions, profits and losses** need to be eliminated. Where there are provisions for unrealised profit and the parent is the seller the adjustment is made against the parent's retained earnings (in the retained earnings working). Where the subsidiary is the seller its retained earnings are adjusted (in the net assets working) thus ensuring that the non-controlling interest (ie, the minority interest) bear their share of the provision.

3.7 Impairments and the non-controlling interest

A subsidiary is subject to impairment review as a cash generating unit. The recoverable amount of the subsidiary is compared with its carrying amount to assess whether an impairment has occurred.

Notional grossing up of goodwill

In order to be comparable with the calculated recoverable amount, the carrying amount of the subsidiary must include 100% of both its net assets and goodwill. Therefore:

(a) where the proportion of net assets method is used to measure the NCI, goodwill must be notionally adjusted so that it represents both the parent and NCI share of goodwill (ie, 100% of goodwill). This involves grossing up the parent's goodwill according to percentage shareholdings; and

(b) where fair value is used to measure the NCI, goodwill already represents 100% of goodwill and no such adjustment is required.

Split of goodwill between the parent and NCI

Where goodwill requires grossing up according to ownership percentages, total goodwill is split in proportion to these ownership percentages.

Where goodwill does not require grossing up, total goodwill is not necessarily split in proportion to ownership percentages due to the control premium.

Context example: Notional goodwill

A acquires 80% of B for £120,000. The net assets at the date of acquisition were £130,000 and the fair value of the 20% non-controlling interest equity shares was £28,000.

Goodwill is calculated as:

	Proportion of net assets method	Fair value method
	£	£
Consideration transferred	120,000	120,000
Non-controlling interest (20% × £130,000)/fair value	26,000	28,000
	146,000	148,000
Net assets of acquiree	(130,000)	(130,000)
Goodwill	16,000	18,000
Attributable to:		
Parent	16,000	16,000
NCI [£28,000 – (20% × £130,000)]	n/a	2,000

For the purposes of an impairment review, the goodwill calculated using the proportion of net assets method is notionally adjusted as follows:

	£
Parent goodwill	16,000
Notional NCI goodwill (20%/80% × £16,000)	4,000
	20,000

In other words, the notional goodwill attributable to the non-controlling interest calculated here includes an element of control premium which is not evident when calculating goodwill attributable to the non-controlling interest using the fair value method.

Allocation of the impairment loss to parent / NCI

IFRS 3 has amended IAS 36, *Impairment of Assets* to require that any impairment loss is allocated 'on the same basis as that on which profit or loss is allocated'. This is likely to correspond to ownership percentages.

Therefore in the illustration above, any impairment loss to goodwill is allocated 80% to the parent and 20% to the NCI.

(a) Where the proportion of net assets method is used and goodwill is notionally calculated for the NCI, this split corresponds exactly to the split of goodwill. Assuming an impairment of £10,000:

	Parent	NCI
	£	£
Goodwill	16,000	4,000
Impairment (80%/20% × £10,000)	(8,000)	(2,000)
	8,000	2,000
Impairment of goodwill	50%	50%

Thus half the total goodwill has been impaired, being half of the parent's goodwill and half of the NCI's notional goodwill.

(b) Where the fair value method is used, and there is a control premium, such that the parent and NCI goodwill are not in proportion, then any impairment is not in proportion to the starting goodwill. This time assuming an impairment of £9,000:

	Parent	NCI
	£	£
Goodwill	16,000	2,000
Impairment (80%/20% × £9,000)	(7,200)	(1,800)
	8,800	200
Impairment of goodwill	45%	90%

3.8 Restructuring and future losses

An acquirer **should not recognise liabilities for future losses** or other costs expected to be incurred as a result of the business combination.

IFRS 3 explains that a plan to restructure a subsidiary following an acquisition is not a present obligation of the acquiree at the acquisition date. Neither does it meet the definition of a contingent liability. Therefore, an acquirer **should not recognise a liability for** such **a restructuring plan** as part of allocating the cost of the combination unless the subsidiary was already committed to the plan before the acquisition.

This **prevents creative accounting**. An acquirer cannot set up a provision for restructuring or future losses of a subsidiary and then release this to profit or loss in subsequent periods in order to reduce losses or smooth profits.

3.9 Intangible assets

The acquiree may have **intangible assets**, such as development expenditure. These can be recognised separately from goodwill only if they are **identifiable**. An intangible asset is identifiable only if it:

(a) is **separable** ie, capable of being separated or divided from the entity and sold, transferred or exchanged, either individually or together with a related contract, asset or liability; or

(b) arises from **contractual or other legal rights**.

3.10 Contingent liabilities

Contingent liabilities of the acquirer are **recognised** if their **fair value can be measured reliably**. A **contingent liability** must be recognised even if the outflow is not probable, provided there is a present obligation.

This is a departure from the normal rules in IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*; contingent liabilities are not normally recognised, but only disclosed.

After their initial recognition, the acquirer should measure contingent liabilities that are recognised separately at the higher of:

(a) the amount that would be recognised in accordance with IAS 37; and

(b) the amount initially recognised.

3.11 Other exceptions to the recognition or measurement principles

(a) **Deferred tax:** Use IAS 12 values

(b) **Employee benefits:** Use IAS 19 values

(c) **Indemnification assets:** Measurement should be consistent with the measurement of the indemnified item, for example an employee benefit or a contingent liability

(d) **Reacquired rights**: Value on the basis of the remaining contractual term of the related contract regardless of whether market participants would consider potential contractual renewals in determining its fair value

(e) **Share-based payment**: Use IFRS 2 values

(f) **Assets held for sale**: Use IFRS 5 values

3.12 Goodwill arising on the acquisition

Goodwill should be carried in the statement of financial position at **cost less any accumulated impairment losses**. The treatment of goodwill was covered in detail in your earlier studies.

3.13 Adjustments after the initial accounting is complete

Sometimes the fair values of the acquiree's identifiable assets, liabilities or contingent liabilities or the cost of the combination can only be measured **provisionally** by the **end of the period in which the combination takes place**. In this situation, the acquirer **should account for the combination using those provisional values**. The acquirer should **recognise any adjustments** to those provisional values as a result of completing the initial accounting:

(a) **within 12 months** of the acquisition date

(b) **from** the acquisition date (ie, retrospectively)

This means that:

(a) the **carrying amount** of an item that is recognised or adjusted as a result of completing the initial accounting shall be calculated **as if its fair value** at the acquisition date **had been recognised from that date**; and

(b) **goodwill should be adjusted** from the acquisition date by an amount equal to the adjustment to the fair value of the item being recognised or adjusted.

Any further adjustments after the initial accounting is complete should be **recognised only to correct an error** in accordance with IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*. Any subsequent changes in estimates are dealt with in accordance with IAS 8 (ie, the effect is recognised in the current and future periods). IAS 8 requires an entity to account for an error correction retrospectively, and to present financial statements as if the error had never occurred by restating the comparative information for the prior period(s) in which the error occurred.

3.14 Reverse acquisitions

IFRS 3 also addresses a certain type of acquisition, known as a **reverse acquisition** or **reverse takeover**. This is where Company A acquires ownership of Company B through a share exchange. (For example, a private entity may arrange to have itself 'acquired' by a smaller public entity as a means of obtaining a stock exchange listing.) The number of shares issued by Company A as consideration to the shareholders of Company B is so great that control of the combined entity after the transaction is with the shareholders of Company B.

In legal terms Company A may be regarded as the parent or continuing entity, but IFRS 3 states that, as it is the Company B shareholders who control the combined entity, **Company B should be treated as the acquirer**. Company B should apply the acquisition method to the assets and liabilities of Company A.

Context example: Reverse acquisition

On 1 January 20X5, ABC's share capital was 10,000 ordinary shares, quoted on a public exchange, and the unquoted share capital of DEF was 24,000 ordinary shares. On that date ABC's shares were quoted at £20. ABC issued 30,000 new shares, and then exchanged them for the entire share capital of DEF. The fair value of DEF's shares on 1 January 20X5 was agreed by the professional advisers to both ABC and DEF as £62.

After the acquisition, the relative interests of the two shareholder groups in ABC were as follows.

	Shares held	**% of total**
ABC shareholders	10,000	25
DEF shareholders	30,000	75
	40,000	100

As the DEF shareholder group controls the combined entities, DEF is treated as the acquirer and ABC as the acquiree.

If DEF had issued enough of its own shares to give ABC shareholders a 25% interest in DEF, it would have had to issue 8,000 shares (ie, 25/75 of 24,000 shares). DEF's share capital would then have been 32,000 (24,000 + 8,000) and the ABC shareholders' interest would have been 8,000 so 25%.

The consideration for the acquisition is £496,000, being 8,000 DEF shares at their agreed fair value of £62.

4 IFRS 13, *Fair Value Measurement* (business combination aspects)

Section overview

- The accounting requirements and disclosures of the **fair value exercise** are covered by **IFRS 3**. **IFRS 13**, *Fair Value Measurement* gives extensive guidance on how the fair value of assets and liabilities should be established.
- Business combinations are accounted for using the **acquisition method.**

4.1 Fair value

The general rule under IFRS 3 is that the subsidiary's assets and liabilities **must be measured at fair value** except in **limited, stated cases**. The assets and liabilities must:

(a) meet the definitions of assets and liabilities in the IASB *Conceptual Framework*; and

(b) be part of what the acquiree (or its former owners) exchanged in the business combination rather than the result of separate transactions.

IFRS 13, *Fair Value Measurement* provides extensive guidance on how the fair value of assets and liabilities should be established.

This standard requires that the following are considered in measuring fair value:

(a) The asset or liability being measured

(b) The principal market (i.e., that where the most activity takes place) or where there is no principal market, the most advantageous market (i.e., that in which the best price could be achieved) in which an orderly transaction would take place for the asset or liability

(c) The highest and best use of the asset or liability and whether it is used on a standalone basis or in conjunction with other assets or liabilities

(d) Assumptions that market participants would use when pricing the asset or liability

Having considered these factors, IFRS 13 provides a hierarchy of inputs for arriving at fair value. It requires that Level 1 inputs are used where possible:

Level 1	Quoted prices in active markets for identical assets that the entity can access at the measurement date
Level 2	Inputs other than quoted prices that are directly or indirectly observable for the asset
Level 3	Unobservable inputs for the asset

Worked example: Examples of fair value and business combinations

For non-financial assets, fair value is decided based on the highest and best use of the asset as determined by a market participant. The following examples, adapted from the illustrative examples to IFRS 13, demonstrate what is meant by this.

1 **Example: Land (Based on IFRS 13: IE7)**

Anscome Co has acquired land in a business combination. The land is currently developed for industrial use as a site for a factory. The current use of land is presumed to be its highest and best use unless market or other factors suggest a different use. Nearby sites have recently been developed for residential use as sites for high-rise apartment buildings. On the basis of that development and recent zoning and other changes to facilitate that development, Anscome determines that the land currently used as a site for a factory could be developed as a site for residential use (ie, for high-rise apartment buildings) because market participants would take into account the potential to develop the site for residential use when pricing the land.

Requirement

How would the highest and best use of the land be determined?

2 **Example: Research and development project (Based on IFRS 13: IE9)**

Searcher acquires a research and development (R&D) project following a business combination. Searcher does not intend to complete the project. If completed, the project would compete with one of its own projects (to provide the next generation of the entity's commercialised technology). Instead, the entity intends to hold (ie, lock up) the project to prevent its competitors from obtaining access to the technology. In doing this the project is expected to provide defensive value, principally by improving the prospects for the entity's own competing technology.

If it could purchase the R&D project, Developer Co would continue to develop the project and that use would maximise the value of the group of assets or of assets and liabilities in which the project would be used (ie, the asset would be used in combination with other assets or with other assets and liabilities). Developer Co does not have similar technology.

Requirement

How would the fair value of the project be measured?

3 **Example: Decommissioning liability (Based on IFRS 13: IE35)**

Deacon assumes a decommissioning liability in a business combination. It is legally required to dismantle a power station at the end of its useful life, which is estimated to be 20 years.

Requirement

How would the decommissioning liability be measured?

Solution

1 The highest and best use of the land would be determined by comparing both of the following:

(1) The value of the land as currently developed for industrial use (i.e., the land would be used in combination with other assets, such as the factory, or with other assets and liabilities)

(2) The value of the land as a vacant site for residential use, taking into account the costs of demolishing the factory and other costs (including the uncertainty about whether the entity would be able to convert the asset to the alternative use) necessary to convert the land to a vacant site (i.e., the land is to be used by market participants on a standalone basis)

The highest and best use of the land would be determined on the basis of the higher of those values.

2 The fair value of the project would be measured on the basis of the price that would be received in a current transaction to sell the project, assuming that the R&D would be used with its complementary assets and the associated liabilities and that those assets and liabilities would be available to Developer Co.

3 Because this is a business combination, Deacon must measure the liability at fair value in accordance with IFRS 13, rather than using the best estimate measurement required by IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

Deacon will use the expected present value technique to measure the fair value of the decommissioning liability. If Deacon were contractually committed to transfer its decommissioning liability to a market participant, it would conclude that a market participant would use all of the following inputs, probability weighted as appropriate, when estimating the price it would expect to receive.

(1) Labour costs

(2) Allocated overhead costs

(3) The compensation that a market participant would generally receive for undertaking the activity, including profit on labour and overhead costs and the risk that the actual cash outflows might differ from those expected

(4) The effect of inflation

(5) The time value of money (risk-free rate)

(6) Non-performance risk, including Deacon's own credit risk

As an example of how the probability adjustment might work, Deacon values labour costs on the basis of current marketplace wages adjusted for expected future wage increases. It determines that there is a 20% probability that the wage bill will be £15 million, a 30% probability that it will be £25 million and a 50% probability that it will be £20 million. Expected cash flows will then be (20% × £15m) + (30% × £25m) + (50% × £20m) = £20.5m. The probability assessments will be developed on the basis of Deacon's knowledge of the market and experience of fulfilling obligations of this type.

Interactive question 3: Goodwill on consolidation

Tyzo plc prepares its financial statements to 31 December. On 1 September 20X7 Tyzo plc acquired 6 million £1 shares in Kono Ltd at £2 per share. The purchase was financed by an additional issue of loan stock at an interest rate of 10%. At that date Kono Ltd produced the following interim financial information.

	£m
Non-current assets	
Property, plant and equipment (Note 1)	16.0
Current assets	
Inventories (Note 2)	4.0
Receivables	2.9
Cash and cash equivalents	1.2
	8.1
Total assets	24.1
Equity and liabilities	
Equity	
Share capital (£1 shares)	
	8.0
Reserves	4.4
	12.4

	£m
Non-current liabilities	
Long-term loan (Note 3)	4.0
Current liabilities	
Trade payables	3.2
Provision for taxation	0.6
Bank overdraft	3.9
	7.7
Total equity and liabilities	24.1

Notes

1 Please see the table below for information related to the property, plant and equipment of Kono Ltd at 1 September 20X7.

2 The inventories of Kono Ltd in hand at 1 September 20X7 consisted of raw materials at cost. They would have cost £4.2 million to replace at 1 September 20X7.

3 The long-term loan of Kono Ltd carries a rate of interest of 10% per annum, payable on 31 August annually in arrears. The loan is redeemable at par on 31 August 20Y1. The interest cost is representative of current market rates. The accrued interest payable by Kono Ltd at 31 December 20X7 is included in the trade payables of Kono Ltd at that date.

4 On 1 September 20X7 Tyzo plc took a decision to rationalise the group so as to integrate Kono Ltd. The costs of the rationalisation were estimated to total £3 million and the process was due to start on 1 March 20X8. No provision for these costs has been made in any of the financial statements given above.

5 Kono Ltd has disclosed a contingent liability of £200,000 in its interim financial statements relating to litigation.

6 Tyzo Group values the non-controlling interest using the proportion of net assets method.

Property, plant and equipment

	£m
Gross replacement cost	28.4
Net replacement cost	16.8
Economic value	18.0
Net realisable value	8.0

Requirement

Compute the goodwill on consolidation of Kono Ltd that will be included in the consolidated financial statements of Tyzo plc for the year ended 31 December 20X7, explaining your treatment of the items mentioned above. You should refer to the provisions of relevant accounting standards.

See **Answer** at the end of this chapter.

Professional skills focus: Assimilating and using information

There is a considerable amount of information to assimilate before you can proceed to the goodwill calculation. Consider doing the explanations first, then when you come to the calculation you will know what to do.

5 IAS 28, *Investments in Associates and Joint Ventures*

Section overview

- **IAS 28** deals with accounting for associates and joint ventures using the **equity method**.
- An associate exists where there is '**significant influence**'.
- The criteria for identifying a joint venture are contained in **IFRS 11**.
- The **accounting** for associates and joint ventures is **identical**.

IAS 28 does not apply to investments in associates or joint ventures held by venture capital organisations, mutual funds, unit trusts and similar entities that are measured at fair value in accordance with IFRS 9.

IAS 28 requires investments in associates to be accounted for using the equity method, **unless** the investment is classified as 'held for sale' in accordance with IFRS 5, in which case it should be accounted for under IFRS 5.

An investor is **exempt** from applying the equity method if (IAS 28.17):

(a) it is a parent exempt from preparing consolidated financial statements under IAS 27 (Revised); or

(b) all of the following apply:

  (1) The investor is a **wholly owned subsidiary** or it is a **partially owned subsidiary** of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the investor not applying the equity method.

  (2) Its securities are **not publicly traded**.

  (3) It is **not in the process of issuing securities** in public securities markets.

  (4) The **ultimate or intermediate parent** publishes consolidated financial statements that comply with International Financial Reporting Standards.

IAS 28 **does not allow** an investment in an associate to be excluded from equity accounting when an investee operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor. Significant influence must be lost before the equity method ceases to be applicable.

The use of the equity method should be **discontinued** from the date that the investor **ceases to have significant influence**.

From that date, the investor shall account for the investment in accordance with IFRS 9. The fair value of the retained interest must be regarded as its fair value on initial recognition as a financial asset under IFRS 9.

5.1 Separate financial statements of the investor

In accordance with IAS 27, *Separate Financial Statements* where an entity prepares separate financial statements it must account for associates (and joint ventures) in its separate financial statements in one of the following ways:

- Accounted for at **cost**
- In accordance with **IFRS 9**
- Using the equity method as described in IAS 28, *Investments in Associates and Joint Ventures*

5.2 Application of the equity method: consolidated accounts

The **equity method** should be applied in the consolidated accounts as follows:

(a) **Statement of financial position** includes investment in associate at cost plus (or minus) the group's share of the associate's post-acquisition profits (or losses) minus any impairments in the investment to date.

(b) **Profit or loss (statement of profit or loss and other comprehensive income):** group share of associate's profit after tax.

(c) **Other comprehensive income (statement of profit or loss and other comprehensive income):** group share of associate's other comprehensive income after tax.

The investment in the associate will also include any other long-term interests in the associate, for example preference shares or long-term receivables or loans.

IFRS 9 sets out a list of indications that a financial asset (including an associate) may have become impaired.

Many of the procedures required to apply the equity method are the same as are required for full consolidation. In particular, **fair value adjustments** are required and the group share of **intra-group unrealised profits** must be excluded.

Worked example: Associate

P Co, a company with subsidiaries, acquires 25,000 of the 100,000 £1 ordinary shares in A Co for £60,000 on 1 January 20X8. In the year to 31 December 20X8, A Co earns profits after tax of £24,000, from which it declares and pays a dividend of £6,000.

Requirement

How will A Co's results be accounted for in the individual and consolidated accounts of P Co for the year ended 31 December 20X8?

Solution

In the **individual accounts** of P Co, the investment will be recorded on 1 January 20X8 at cost. Unless there is an impairment in the value of the investment (see below), most companies will choose the policy that this amount (the cost) will remain in the individual statement of financial position of P Co permanently. The only entry in P Co's individual statement of profit or loss and other comprehensive income will be to record dividends received. For the year ended 31 December 20X8, P Co will:

DEBIT	Cash (£6,000 × 25%)	£1,500	
CREDIT	Income from shares in associated companies		£1,500

In the **consolidated accounts** of P Co equity accounting will be used. Consolidated profit after tax will include the group's share of A Co's profit after tax (25% × £24,000 = £6,000).

In the consolidated statement of financial position the non-current asset 'Investment in associates' will be stated at £64,500, being cost of £60,000 plus the group's share of post-acquisition retained profits of £4,500 ((24,000 – 6,000) × 25%).

5.3 Transactions between a group and its associate

Unlike for subsidiaries, trading transactions are not cancelled out. However, any **unrealised profits** on these transactions **should be eliminated**, but only to the extent of **the group's share**.

Where the **associate sells to the parent/subsidiary** the double entry is as follows, where A% is the parent's holding in the associate, and PURP is the provision for unrealised profit:

DEBIT	Retained earnings of parent/subsidiary	PURP × A%	
CREDIT	Group inventories/PPE		PURP × A%

Where the **parent/subsidiary sells to the associate**:

DEBIT	Retained earnings of parent/subsidiary	PURP × A%	
CREDIT	Investment in associate		PURP × A%

5.4 Associate's losses

When the equity method is being used and the investor's share of losses of the associate equals or exceeds its interest in the associate, the investor should **discontinue** including its share of further losses. The investment is reported at nil value. After the investor's interest is reduced to nil, **additional losses** should only be recognised where the investor has incurred obligations or made payments on behalf of the associate (for example, if it has guaranteed amounts owed to third parties by the associate).

5.5 Impairment losses

Any impairment loss is recognised in accordance with IAS 36, *Impairment of Assets* for each associate individually.

6 IFRS 11, *Joint Arrangements*

Section overview

- IFRS 11 classes joint arrangements as either **joint operations** or **joint ventures**.
- The classification of a joint arrangement as a joint operation or a joint venture depends on the **rights and obligations** of the parties to the arrangement.
- Joint arrangements are often found when each party can **contribute in different ways** to the activity. For example, one party may provide finance, another purchases or manufactures goods, while a third offers its marketing skills.

6.1 Definitions

The IFRS begins by listing some important definitions.

Definitions

Joint arrangement: An arrangement of which two or more parties have joint control.

Joint control: The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

Joint operation: A joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets and obligations for the liabilities relating to the arrangement.

Joint venture: A joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement. (IFRS 11, Appendix A)

6.2 Forms of joint arrangement

IFRS 11 classes joint arrangements as either joint operations or joint ventures. The classification of a joint arrangement as a joint operation or a joint venture depends on the rights and obligations of the parties to the arrangement.

A **joint operation** is a joint arrangement whereby the parties that have joint control (the joint operators) have rights to the assets, and obligations for the liabilities, of that joint arrangement. A joint arrangement that is **not structured through a separate entity** is always a joint operation.

A **joint venture** is a joint arrangement whereby the parties that have **joint control** (the joint venturers) of the arrangement have **rights to the net assets** of the arrangement.

A **joint arrangement** that is structured through a **separate entity** may be either a joint operation or a joint venture. In order to ascertain the classification, the parties to the arrangement should assess the terms of the contractual arrangement together with any other facts or circumstances to assess whether they have:

- rights to the assets, and obligations for the liabilities, in relation to the arrangement (indicating a joint operation); and
- rights to the net assets of the arrangement (indicating a joint venture).

Detailed guidance is provided in the appendices to IFRS 11 in order to help this assessment, giving consideration to, for example, the wording contained within contractual arrangements.

IFRS 11 summarises the basic issues that underlie the classifications in the following diagram.

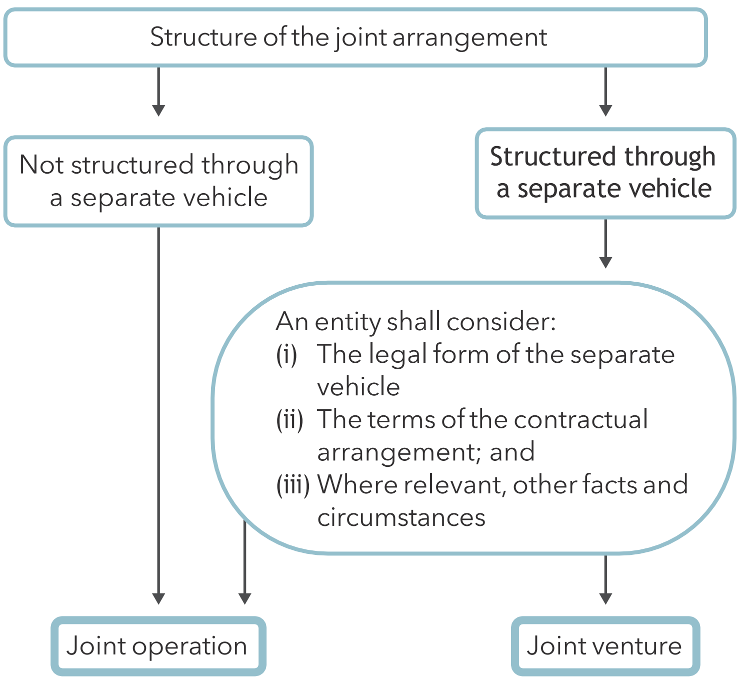


Figure 20.1: Joint Arrangements

(Source: IFRS 11: AG. B21)

6.2.1 Contractual arrangement

The existence of a contractual agreement distinguishes a joint arrangement from an investment in an associate. **If there is no contractual arrangement, then a joint arrangement does not exist**.

Evidence of a contractual arrangement could be in one of several forms.

- **Contract** between the parties
- **Minutes** of discussion between the parties
- Incorporation in the **articles or by-laws** of the joint venture

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The contractual arrangement is usually **in writing**, whatever its form, and it will deal with the following issues surrounding the joint venture.

- **Its activity, duration and reporting obligations**
- The appointment of its **board of directors** (or equivalent) and the **voting rights** of the parties
- **Capital contributions** to it by the parties
- How its output, income, expenses or results are **shared** between the parties

It is the contractual arrangement which establishes **joint control** over the joint venture, so that no single party can control the activity of the joint venture on its own.

The terms of the contractual arrangement are key to deciding whether the arrangement is a joint venture or joint operation. IFRS 11 includes a table of issues to consider and explains the influence of a range of points that could be included in the contract. The table is summarised below.

	Joint operation	**Joint venture**
The terms of the contractual arrangement	The parties to the joint arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.	The parties to the joint arrangement have rights to the net assets of the arrangement (ie, it is the separate vehicle, not the parties, that has rights to the assets, and obligations for the liabilities).
Rights to assets	The parties to the joint arrangement share all interests (eg, rights, title or ownership) in the assets relating to the arrangement in a specified proportion (eg, in proportion to the parties' ownership interest in the arrangement or in proportion to the activity carried out through the arrangement that is directly attributed to them).	The assets brought into the arrangement or subsequently acquired by the joint arrangement are the arrangement's assets. The parties have no interests (ie, no rights, title or ownership) in the assets of the arrangement.
Obligations for liabilities	The parties share all liabilities, obligations, costs and expenses in a specified proportion (eg, in proportion to their ownership interest in the arrangement or in proportion to the activity carried out through the arrangement that is directly attributed to them).	The joint arrangement is liable for the debts and obligations of the arrangement. The parties are liable to the arrangement only to the extent of their respective: • investments in the arrangement; or • obligations to contribute any unpaid or additional capital to the arrangement; or • both.
	The parties to the joint arrangement are liable for claims by third parties.	Creditors of the joint arrangement do not have rights of recourse against any party.

	Joint operation	Joint venture
Revenues, expenses, profit or loss	The contractual arrangement establishes the allocation of revenues and expenses on the basis of the relative performance of each party to the joint arrangement. For example, the contractual arrangement might establish that revenues and expenses are allocated on the basis of the capacity that each party uses in a plant operated jointly.	The contractual arrangement establishes each party's share in the profit or loss relating to the activities of the arrangement.
Guarantees	The provision of guarantees to third parties, or the commitment by the parties to provide them, does not, by itself, determine that the joint arrangement is a joint operation.	

6.2.2 Section summary

- There are two **types of joint arrangement**: joint ventures and jointly controlled operations.
- A **contractual arrangement** must exist which establishes joint control.
- **Joint control** is important: one **operator** must not be able to govern the financial and operating policies of the joint venture.

Professional skills focus: Concluding, recommending and communicating

The nature of a joint arrangement may not be immediately apparent. If asked to determine whether a joint arrangement is a joint operation or a joint venture, you should explain your reasons clearly.

6.3 Accounting treatment

The accounting treatment of joint arrangements depends on whether the arrangement is a joint venture or joint operation.

6.3.1 Accounting for joint operations

IFRS 11 requires that a joint operator recognises line by line the following in relation to its interest in a joint operation:

(a) Its assets, including its share of any jointly held assets

(b) Its liabilities, including its share of any jointly incurred liabilities

(c) Its revenue from the sale of its share of the output arising from the joint operation

(d) Its share of the revenue from the sale of the output by the joint operation

(e) Its expenses, including its share of any expenses incurred jointly

This treatment is applicable in both the separate and consolidated financial statements of the joint operator.

Interactive question 4: Joint arrangement

Can you think of examples of situations where this type of joint arrangement might take place?

See **Answer** at the end of this chapter.

6.3.2 Joint ventures

IFRS 11 and **IAS 28** require **joint ventures** to be accounted for using **the equity method**.

The rules for equity accounting are included in IAS 28. These were covered in your Professional studies and are revised above.

Application of IAS 28 to joint ventures

The consolidated statement of financial position is prepared by:

- including the interest in the joint venture at cost plus share of post-acquisition total comprehensive income; and
- including the group share of the post-acquisition total comprehensive income in group reserves.

The consolidated statement of profit or loss and other comprehensive income will include:

- the group share of the joint venture's profit or loss; and
- the group share of the joint venture's other comprehensive income.

The use of the equity method should be **discontinued** from the date on which the joint venturer ceases to have joint control over, or have significant influence on, a joint venture.

Transactions between a joint venturer and a joint venture Downstream transactions

A joint venturer may **sell or contribute assets** to a joint venture so making a profit or loss. Any such gain or loss should, however, only be recognised to the extent that it reflects the substance of the transaction.

Therefore:

- only the **gain** attributable to the interest of the other joint venturers should be recognised in the financial statements; and
- the full amount of any **loss** should be recognised when the transaction shows evidence that the net realisable value of current assets is less than cost, or that there is an impairment loss.

Upstream transactions

When a joint venturer purchases assets from a joint venture, the joint venturer should not recognise its share of the profit made by the joint venture on the transaction in question until it resells the assets to an independent third party ie, until the profit is realised.

Losses should be treated in the same way, **except** losses should be recognised immediately if they represent a reduction in the net realisable value of current assets, or a permanent decline in the carrying amount of non-current assets.

6.3.3 Section summary

- **Joint operations** are accounted for by including the investor's share of assets, liabilities, income and expenses as per the contractual arrangement.
- **Joint ventures** are accounted for using the **equity method** as under IAS 28.

7 Question technique and practice

Section overview

Although you have studied consolidation at Professional Level, it is vitally important that you have retained this knowledge and can put it into practice. This section summarises the basic question techniques and provides question practice before you move on to the more advanced topics of changes in group structure and foreign currency transactions. A number of standard workings should be used when answering consolidation questions.

7.1 Question technique for consolidated statement of financial position

As questions increase in complexity a formal pattern of workings is needed. Review the standard workings below.

(1) Establish group structure

P Ltd

80%

S Ltd

(2) **Set out net assets of S Ltd**

	At year end	At acquisition	Post-acquisition
	£	£	£
Share capital	X	X	X
Retained earnings	X	X	X
	X	X	X

(3) **Calculate goodwill**

	£
Consideration transferred	X
Plus Non-controlling interest at acquisition	X
	X
Less net assets at acquisition (see W2)	(X)

	£
	X
Impairment to date	(X)
Balance c/f	X

(4) Calculate non-controlling interest (NCI) at year end

	£
At acquisition (NCI% × net assets (W2) or fair value)	X
Share of post-acquisition profits and other reserves (NCI% × post-acquisition (W2))	X
	X

(5) Calculate retained earnings

	£
P Ltd (100%)	X
S Ltd (share of post-acquisition retained earnings (see W2))	X
Goodwill impairment to date (see W3)	(X)
Group retained earnings	X

Note: You should use the proportionate basis for measuring the NCI at the acquisition date unless a question specifies the fair value basis.

7.2 Consolidated statement of profit or loss

As with the statement of financial position, as questions increase in complexity a formal pattern of workings is needed.

(1) **Establish group structure**

P Ltd

↓ 80%

S Ltd

(2) **Prepare consolidation schedule**

	P	**S**	**Adj**	**Consol**
	£	**£**	**£**	**£**
Revenue	X	X	(X)	X
Cost of sales – Per Q	(X)	(X)	X	(X)
– PURP (seller's books)	(X)	or (X)		
Expenses – Per Q	(X)	(X) (X)(X)		
– Goodwill impairment (if any)*			(X)	(X)
Tax – Per Q	(X)	(X)		(X)
Profit		X		

May need workings for (eg)

- PURPs
- Goodwill impairment

(3) **Calculate non-controlling interest**

				£
S PAT × NCI%	NCI%	×	=	X

* If the non-controlling interest is measured at fair value, then the NCI% of the impairment loss will be debited to the NCI. This is based on the NCI shareholding. For instance, if the parent has acquired 75% of the subsidiary and the NCI is measured at fair value, then 25% of any goodwill impairment will be debited to NCI.

Professional skills focus: Structuring problems and solutions

However complex consolidation questions may be at Advanced Level, following the above step-by- step structure will get you many of the marks. Practice is essential so that each step becomes routine.

Interactive question 5: Consolidation technique 1

At 1 July 20X8 Anima plc had investments in two companies: Orient Ltd and Oxendale Ltd. On 1 April 20X9 Anima plc purchased 85% of the ordinary share capital of Carnforth Ltd for £3 million.

Extracts from the draft individual financial statements of the four companies for the year ended 30 June 20X9 are shown below:

Statements of profit or loss

	Anima plc	Orient Ltd	Carnforth Ltd	Oxendale Ltd
	£	£	£	£
Revenue	1,410,500	870,300	640,000	760,090
Cost of sales	(850,000)	(470,300)	(219,500)	(345,000)
Gross profit	560,500	400,000	420,500	415,090
Operating expenses	(103,200)	(136,000)	(95,120)	(124,080)
Profit before taxation	457,300	264,000	325,380	291,010
Income tax expense	(137,100)	(79,200)	(97,540)	(86,400)
Profit for the year	320,200	184,800	227,840	204,610

Statements of financial position (extracts) at year end

	Anima plc	Orient Ltd	Carnforth Ltd	Oxendale Ltd
	£	£	£	£
Equity				
Ordinary share capital (£1 shares)	4,000,000	3,500,000	2,000,000	3,000,000
Retained earnings	1,560,000	580,000	605,000	340,000
	5,560,000	4,080,000	2,605,000	3,340,000

Additional information:

(1) A number of years ago Anima plc acquired 2.1 million of Orient Ltd's ordinary shares and 900,000 of Oxendale Ltd's ordinary shares. Balances on retained earnings at the date of acquisition were £195,000 for Orient Ltd and £130,000 for Oxendale Ltd. The non-controlling interest and goodwill arising on the acquisition of Orient Ltd were both calculated using the fair value method; the fair value of the non-controlling interest at acquisition was £1,520,000.

(2) At the date of acquisition the fair values of Carnforth Ltd's assets and liabilities were the same as their carrying amounts except for its head office (land and buildings) which had a fair value of £320,000 in excess of its carrying amount. The split of the value of land to buildings is 50:50 and the buildings had a remaining life of 40 years at 1 April 20X9. Carnforth Ltd's profits accrued evenly over the current year. The non-controlling interest and goodwill arising on the acquisition of Carnforth Ltd were both calculated using the proportionate method.

(3) During the year Anima plc sold goods to Orient Ltd and Oxendale Ltd at a mark-up of 15%. Anima plc recorded sales of £149,500 and £207,000 to Orient Ltd and Oxendale Ltd respectively during the year. At the year-end inventory count Orient Ltd was found still to be holding half these goods and Oxendale Ltd still held one-third.

(4) Anima plc has undertaken annual impairment reviews in respect of all its investments and at 30 June 20X9 an impairment loss of £10,000 had been identified in respect of Oxendale Ltd.

Requirement

Prepare the consolidated statement of profit or loss of Anima plc for the year ended 30 June 20X9 and an extract from the consolidated statement of financial position as at the same date showing all figures that would appear as part of equity.

See **Answer** at the end of this chapter.

Interactive question 6: Consolidation technique 2

Preston plc has investments in two companies, Longridge Ltd and Chipping Ltd. The draft summarised statements of financial position of the three companies at 31 March 20X4 are shown below:

	Preston plc	**Longridge Ltd**	**Chipping Ltd**
	£	**£**	**£**
Assets			
Non-current assets			
Property, plant and equipment	660,700	635,300	261,600
Intangibles	101,300	72,000	–
Investments	350,000		
Current assets	1,112,000	707,300	261,600
Inventories	235,400	195,900	65,700
Trade and other receivables	174,900	78,800	56,600
Cash and cash equivalents	23,700	11,900	3,400
	434,000	286,600	125,700
Total assets	1,546,000	993,900	387,300
Equity and liabilities			
Equity			
Ordinary share capital (£1 shares)	100,000	500,000	200,000
Revaluation surplus	125,000	–	–
Retained earnings	1,084,800	312,100	12,000
	1,309,800	812,100	212,000
	Preston plc	**Longridge Ltd**	**Chipping Ltd**
	£	**£**	**£**
Current liabilities			
Trade and other payables	151,200	101,800	137,400
Taxation	85,000	80,000	37,900
	236,200	181,800	175,300
Total equity and liabilities	1,546,000	993,900	387,300

Additional information:

(1) Preston plc acquired 75% of Longridge Ltd's ordinary shares on 1 April 20X2 for total cash consideration of £691,000. £250,000 was payable on the acquisition date and the remaining £441,000 two years later, on 1 April 20X4. The directors of Preston plc were unsure how to treat the deferred consideration and have ignored it when preparing the draft financial statements above.

On the date of acquisition Longridge Ltd's retained earnings were £206,700. The non-controlling interest and goodwill arising on the acquisition of Longridge Ltd were both calculated using the proportionate method.

(2) The intangible asset in Longridge Ltd's statement of financial position relates to goodwill which arose on the acquisition of an unincorporated business, immediately before Preston plc purchasing its shares in Longridge Ltd. Cumulative impairments of £18,000 in relation to this goodwill had been recognised by Longridge Ltd as at 31 March 20X4.

The fair values of the remaining assets, liabilities and contingent liabilities of Longridge Ltd at the date of its acquisition by Preston plc were equal to their carrying amounts, with the exception of a building purchased on 1 April 20X0, which had a fair value on the date of acquisition of £120,000. This building is being depreciated by Longridge Ltd on a straight-line basis over 50 years and is included in the above statement of financial position at a carrying amount of £92,000.

(3) Immediately after its acquisition by Preston plc, Longridge Ltd sold a machine to Preston plc. The machine had been purchased by Longridge Ltd on 1 April 20X0 for £10,000 and was sold to Preston plc for £15,000. The machine was originally assessed as having a total useful life of five years and that estimate has never changed.

(4) Chipping Ltd is a joint venture, set up by Preston plc and a fellow venturer on 30 June 20X2. Preston plc paid cash of £100,000 for its 40% share of Chipping Ltd.

(5) During the current year Preston plc sold goods to Longridge Ltd for £12,000 and to Chipping Ltd for £15,000, earning a 20% gross margin on both sales. All these goods were still in the purchasing companies' inventories at the year end.

(6) At 31 March 20X4 Preston plc's trade receivables included £50,000 due from Longridge Ltd. However, Longridge Ltd's trade payables included only £40,000 due to Preston plc. The difference was due to cash in transit.

(7) At 31 March 20X4 impairment losses of £25,000 and £10,000 respectively in respect of goodwill arising on the acquisition of Longridge Ltd and the carrying amount of Chipping Ltd need to be recognised in the consolidated financial statements.

In the next financial year, Preston plc decided to invest in a third company, Sawley Ltd. On 1 December 20X4 Preston plc acquired 80% of Sawley Ltd's ordinary shares for £385,000. On the date of acquisition Sawley Ltd's equity comprised share capital of £320,000 and retained earnings of £112,300. Preston plc chose to measure the non-controlling interest at the acquisition date at the non-controlling interest's share of Sawley Ltd's net assets. Goodwill arising on the acquisition of Sawley Ltd has been correctly calculated at £39,160 and will be recognised in the consolidated statement of financial position as at 31 March 20X5.

Requirements

6.1 Prepare the consolidated statement of financial position of Preston plc as at 31 March 20X4.

6.2 Set out the journal entries that will be required on consolidation to recognise the goodwill arising on the acquisition of Sawley Ltd in the consolidated statement of financial position of Preston plc as at 31 March 20X5.

Note: An appropriate discount rate is 5% p.a.

See **Answer** at the end of this chapter.

8 IFRS 12, *Disclosure of Interests in Other Entities*

Section overview

IFRS 12, *Disclosure of Interests in Other Entities* requires disclosure of a reporting entity's interests in other entities in order to help identify the profit or loss and cash flows available to the reporting entity and determine the value of a current or future investment in the reporting entity.

8.1 Objective

The objective of IFRS 12 is to require entities to disclose information that enables the user of the financial statements to evaluate the nature of, and risks associated with, interests in other entities, and the effects of those interests on its financial position, financial performance and cash flows.

This is particularly relevant in light of the financial crisis and recent accounting scandals. The IASB believes that better information about interests in other entities is necessary to help users to identify the profit or loss and cash flows available to the reporting entity and to determine the value of a current or future investment in the reporting entity.

8.2 Scope

IFRS 12 covers disclosures for entities which have interests in the following:

- Subsidiaries
- Joint arrangements (ie, joint operations and joint ventures, see above)
- Associates
- Unconsolidated structured entities

8.3 Structured entity

IFRS 12 defines a structured entity.

Definition

Structured entity: An entity that has been designed so that **voting or similar rights** are **not the dominant factor** in **deciding who controls** the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements.

(IFRS 12, Appendix A)

8.4 Disclosure

IFRS 12, *Disclosure of Interests in Other Entities* provides guidance applicable to consolidated financial statements.

The standard requires disclosure of:

(a) the significant judgements and assumptions made in determining the nature of an interest in another entity or arrangement, and in determining the type of joint arrangement in which an interest is held; and

(b) information about interests in subsidiaries, associates, joint arrangements and structured entities that are not controlled by an investor.

8.4.1 Disclosure of subsidiaries

The following disclosures are required in respect of subsidiaries:

(a) The interest that non-controlling interests have in the group's activities and cash flows, including the name of relevant subsidiaries, their principal place of business, and the interest and voting rights of the non-controlling interests

(b) Nature and extent of significant restrictions on an investor's ability to use group assets and liabilities

(c) Nature of the risks associated with an entity's interests in consolidated structured entities, such as the provision of financial support

(d) Consequences of changes in ownership interest in subsidiary (whether control is lost or not)

8.4.2 Disclosure of associates and joint arrangements

The following disclosures are required in respect of associates and joint arrangements:

(a) Nature, extent and financial effects of an entity's interests in associates or joint arrangements, including name of the investee, principal place of business, the investor's interest in the investee, method of accounting for the investee and restrictions on the investee's ability to transfer funds to the investor

(b) Risks associated with an interest in an associate or joint venture

(c) Summarised financial information, with more detail required for joint ventures than for associates

9 Step acquisitions

Section overview

- Subsidiaries and associates are consolidated/equity accounted for from the date control/significant influence is gained.
- In some cases acquisitions may be achieved in stages. These are known as step acquisitions.

A step acquisition occurs when the parent entity acquires control over the subsidiary in stages, achieved by buying blocks of shares at different times.

Acquisition accounting is only applied when control is achieved.

The date on which control is achieved is the date on which the acquirer should recognise the acquiree's identifiable net assets and any goodwill acquired (or bargain purchase) in the business combination.

Until control is achieved, any pre-existing interest is accounted for in accordance with:

- IFRS 9 in the case of investments in equity instruments
- IAS 28 in the case of associates and joint ventures

9.1 Types of business combination achieved in stages

There are three possible types of business combinations achieved in stages:

(a) A previously held **investment**, say 10% of share capital, with **no significant influence** (accounted for under IFRS 9), is **increased to a controlling holding** of 50% or more.

(b) A **previously held equity investment**, say 35% of share capital, accounted for as an **associate** under IAS 28, is increased to a controlling holding of 50% or more.

(c) A **controlling holding** in a subsidiary is **increased**, say from 60% to 80%.

The first two transactions are treated in the same way, but the third is not. There is a reason for this.

9.2 General principle: 'crossing an accounting boundary'

Under IFRS 3 a business combination occurs only when one entity **obtains control over another**, which is generally when 50% or more has been acquired. The 2008 Deloitte guide: *Business Combinations and Changes in Ownership Interests* calls this '**crossing an accounting boundary**'.

When this happens, the original investment – whether an investment in equity instruments with no significant influence, or an associate – is treated as if it were **disposed of at fair value and reacquired at fair value**. This **previously held interest** at fair value, together with any consideration transferred, is the **'cost' of the combination** used in calculating the goodwill.

If the 50% **boundary is not crossed**, as when a shareholding in an existing subsidiary is increased, the event is treated as a **transaction between owners**.

Whenever you cross the 50% boundary, you revalue, and a gain or loss is reported in profit or loss for the year. If you do not cross the 50% boundary, no gain or loss is reported; instead there is an adjustment to the parent's equity.

The following diagram, adapted from the **Deloitte** guide to IFRS 3, may help you visualise the boundary:

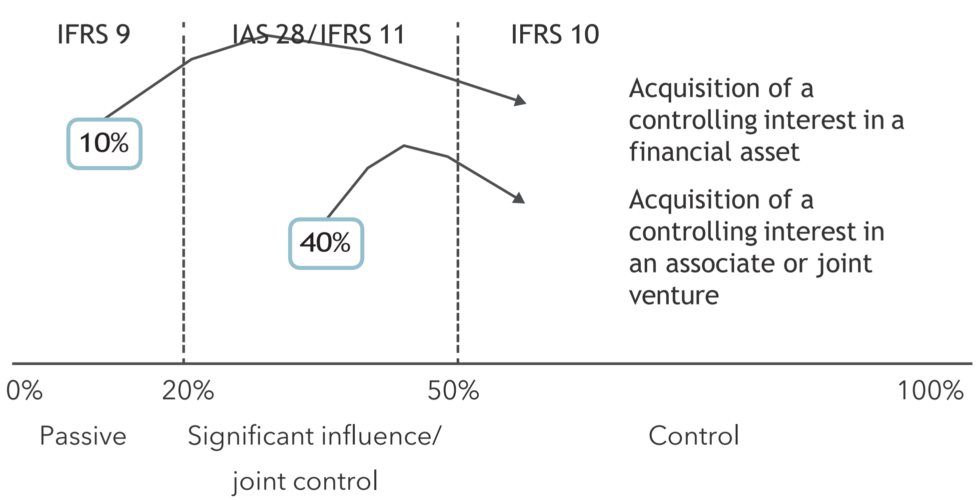


Figure 20.2: Transactions that trigger remeasurement of an existing interest

As you will see from the diagram, the third situation in section 9.1, where an interest in a subsidiary is increased from, say, 60% to 80%, does not involve crossing that all-important 50% threshold.

Likewise, purchases of stakes up to 50% do not involve crossing the boundary, and therefore do not trigger a calculation of goodwill.

Professional skills focus: Assimilating and using information

When tackling exam questions that involve a step-acquisition or a disposal, this skill (assimilating and using information) is vital. You should be able to work out quickly whether an accounting boundary has been crossed, and this will determine the financial reporting treatment.

9.3 Achieving control

When control is achieved:

- any previously held equity shareholding should be treated as if it had been disposed of and then reacquired at fair value at the acquisition date; and
- any gain or loss on remeasurement to fair value should be recognised in profit or loss in the period.

Goodwill is calculated as:

	£
Fair value of consideration paid to acquire control	X

	£
Non-controlling interest (valued using either fair value or the proportion of net assets method)	X
Fair value of previously held equity interest at acquisition date	X X
Fair value of net assets of acquiree	(X)
Goodwill	X

9.3.1 Gain or loss on derecognition

The gain or loss is recognised in profit or loss unless the equity interest previously held was an investment in equity instruments and an irrevocable election was made to hold the investment at fair value through other comprehensive income. In the latter case, in accordance with IFRS 9, *Financial Instruments*, the gain on derecognition of the investment is taken to other comprehensive income, or, in the SOFP, other components of equity.

As we saw in Chapter 16 on financial instruments, for an equity instrument at fair value through other comprehensive income (FVTOCI) the asset's carrying amount is remeasured to fair value at the date of derecognition (IFRS 9: para. 3.2.12) immediately prior to the disposal. A step acquisition from a financial asset to subsidiary is like a disposal of the financial asset. Any change resulting from such a remeasurement is recognised in OCI. Assuming the disposal is at fair value then, as a consequence of the revaluation there is nil profit/loss on disposal recorded in profit or loss. IFRS 9 interacts with IFRS 3, which requires that, in the case of a step acquisition going from a financial asset at FVTOCI to a subsidiary, the financial asset at FVTOCI is revalued in accordance with IFRS 3 para. 42:

"In a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and **recognise the resulting gain or loss, if any, in profit or loss or other comprehensive income, as appropriate**."

It is therefore clear that the gain on revaluation of a financial asset in a step acquisition from financial asset to subsidiary would go through OCI in the case of financial assets at FVTOCI and to profit or loss in the case of financial assets at fair value through profit or loss (FVTPL).

Worked example: Control in stages – previous holding a simple investment

Bath Ltd has 1 million shares in issue. Bristol plc acquired 50,000 shares in Bath Ltd on 1 January 20X6 for £100,000. These shares were classified as a financial asset at fair value through other comprehensive income and on 31 December 20X8 their carrying amount was £230,000 and increases in fair value of £130,000 had been recognised in other comprehensive income and were held in equity. On 1 June 20X9 when the fair value of Bath Ltd's net assets was £4 million, Bristol plc acquired another 650,000 shares in Bath Ltd for £3.9 million. On 1 June 20X9 the fair value of the 50,000 shares already held was £250,000.

Requirement

Show the journal entry required in respect of the 50,000 shareholding on 1 June 20X9 and calculate the goodwill acquired in the business combination on that date assuming that goodwill is valued using the proportion of net assets method.

Solution

Journal entry

		£'000	£'000
DEBIT	Investment in Bath Ltd (250,000 – 230,000)	20	
CREDIT	Other comprehensive income and equity reserve		20

To recognise the gain on the deemed disposal of the shareholding in Bath Ltd existing immediately before control being obtained.

Calculation of goodwill in respect of 70% (5% + 65%) holding in Bath Ltd:

	£'000
Consideration transferred	3,900
Non-controlling interest (30% × £4m)	1,200
Acquisition-date fair value of previously held equity	250
	5,350
Net assets acquired	(4,000)
Goodwill	1,350

Interactive question 7: Control in stages – no previous significant influence

Good, whose year end is 30 June 20X9 has a subsidiary, Will, which it acquired in stages. The details of the acquisition are as follows.

Date of acquisition	Holding acquired %	Retained earnings at acq. \$m	Purchase consideration \$m
1 July 20X7	20	270	120
1 July 20X8	60	450	480

The share capital of Will has remained unchanged since its incorporation at $300 million. The fair values of the net assets of Will were the same as their carrying amounts at the date of the acquisition. Good did not have significant influence over Will at any time before gaining control of Will. The group policy is to measure non-controlling interest at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Requirements

7.1 Calculate the goodwill on the acquisition of Will that will appear in the consolidated statement of financial position at 30 June 20X9.

7.2 Calculate the profit on the derecognition of any previously held investment in Will to be reported in group profit or loss for the year ended 30 June 20X9.

See **Answer** at the end of this chapter.

9.4 Acquisitions that do not result in a change of control

Where an entity increases its investment in an existing subsidiary:

- no gain or loss is recognised;
- goodwill is not remeasured; and
- the difference between the fair value of consideration paid and the change in the non-controlling interest is recognised directly in equity attributable to owners of the parent.

Worked example: Acquisitions that do not result in a change of control

On 1 June 20X6, Santander acquired 70% of the equity of Madrid in exchange for £760,000 cash and 100,000 Santander shares. At this date the fair value of the identifiable net assets of Madrid was £850,000 and the market value of Santander shares was £2.50.

On 31 December 20X8, Santander acquired a further 10% of the equity of Madrid at a cost of £105,000. On this date the identifiable net assets of Madrid were £970,000.

Santander measures the non-controlling interest using the proportion of net assets method.

Requirements

1 What goodwill is recorded in the consolidated statement of financial position at 31 December 20X8, assuming that there is no impairment?

2 What journal adjustment is required on the acquisition of the further 10% of shares?

Solution

1 The goodwill included in the statement of financial position at 31 December 20X8 is that goodwill calculated on the initial acquisition in June 20X6:

	£'000
Consideration (£760,000 + (100,000 × £2.50))	1,010
Non-controlling interest (30% × £850,000)	255
	1,265
Net assets of acquiree	(850)
Goodwill	415

2 The adjustment required is based on the change in the non-controlling interest at the acquisition date:

	£
NCI on 31 December 20X8 based on old interest (30% × £970,000)	291,000
NCI on 31 December 20X8 based on new interest (20% × £970,000)	194,000
Adjustment required	97,000

Therefore:

DEBIT	Non-controlling interest	97,000	
DEBIT	Shareholders' equity (bal fig)	8,000	
CREDIT	Cash		105,000

10 Disposals

Section overview

- Subsidiaries and associates are consolidated/equity accounted for until the date control/significant influence is lost therefore profits need to be time apportioned.
- A gain on disposal must also be calculated, by reference to the fair value of any interest retained in the subsidiary or associate.

An entity may sell all or some of its shareholding in another entity. Full disposals of subsidiaries and associates were covered in FR and are revised here. Other situations which may arise are as follows:

- The sale of shares in a subsidiary such that control is retained
- The sale of shares in a subsidiary such that the subsidiary becomes an associate
- The sale of shares in a subsidiary such that the subsidiary becomes an investment
- The sale of shares in an associate such that the associate becomes an investment

10.1 Crossing an accounting boundary revisited

Under IFRS 3 a gain on disposal occurs only when one entity loses control over another, which is generally when its holding is decreased to less than 50%. As noted above, the Deloitte guide: *Business Combinations and Changes in Ownership Interests* calls this 'crossing an accounting boundary' but in this case the investment is being **reduced**, rather than increased as in sections 9.1 and 9.2 above.

On disposal of a controlling interest, any retained shareholding (an associate or trade investment) is measured at fair value on the date that control is lost. This fair value is used in the calculation of the gain or loss on disposal, and also becomes the carrying amount for subsequent accounting for the retained shareholding.

If the **50%** boundary is **not crossed**, as when the shareholding in a subsidiary is reduced, but control is still retained, the event is treated as a **transaction between owners and no gain or loss is recognised**.

Whenever you cross the 50% boundary, you revalue, and a gain or loss is reported in profit or loss for the year. If you do not cross the 50% boundary, no gain or loss is reported; instead there is an adjustment to the parent's equity.

The following diagram, adapted from the **Deloitte** guide, may help you visualise the boundary:

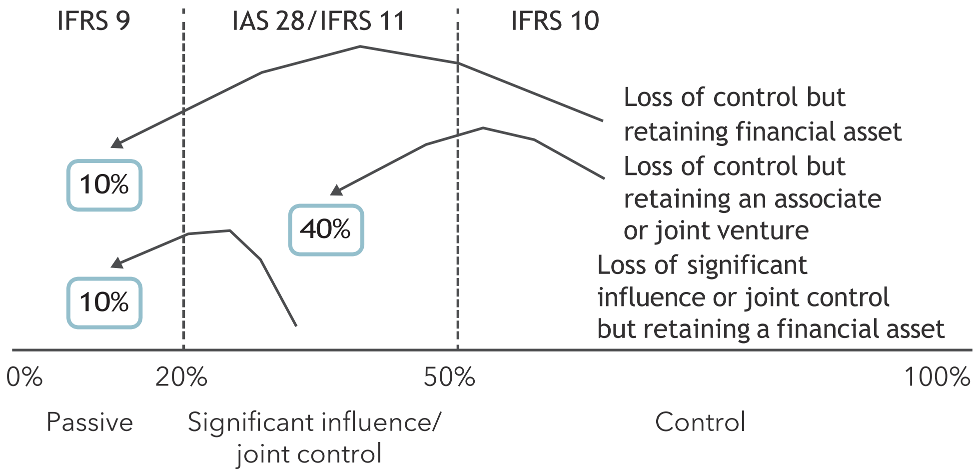


Figure 20.3: Transactions that require remeasurement of a retained interest

The situation where a shareholding in a subsidiary is reduced from, say, 80% to 60% – that is, where control is retained – does not involve crossing that all-important 50% threshold.

10.2 Disposal of a whole subsidiary or associate – revision

10.2.1 Parent company's accounts

In the **parent's individual financial statements** the **profit or loss on** disposal of a subsidiary or associate holding will be calculated as:

	£
Sales proceeds	X
Less carrying amount (cost in P's own statement of financial position)	(X)
Profit (loss) on disposal	X/(X)

10.2.2 Group accounts – disposal of subsidiary Gain or loss on disposal

In the **group financial statements** the **profit or loss on disposal** will be calculated as:

	£	£
Proceeds		X
Less: amounts recognised before disposal:		
net assets of subsidiary	X	
goodwill	X	
non-controlling interest	(X)	
		(X)
Profit/loss		X/(X)

Remember:

(a) If the disposal is mid year:

  (1) a working will be required to calculate both net assets and the non-controlling interest at the disposal date; and

  (2) any dividends declared or paid in the year of disposal and before the disposal date must be deducted from the net assets of the subsidiary if they have not already been accounted for.

(b) Goodwill recognised before disposal is original goodwill arising less any impairments to date.

Worked example: Group gain or loss on disposal

Kingdom acquired 80% of Westville on 1 January 20X5 for £280,000 when Westville had share capital of £100,000 and retained earnings of £188,000. On this date the fair value of the non-controlling interest was £67,000. Kingdom's policy is to value the non-controlling interest using the fair value (ie, full goodwill) method. Goodwill has suffered no impairment since acquisition.

On 30 June 20X8, Kingdom disposed of its investment in Westville, raising proceeds of £350,000. The following are extracts from the accounts of Westville for the year ended 31 December 20X8:

	£'000
Retained earnings b/f	215
Profit for the year	24

A final dividend for 20X7 of £10,000 was paid on 14 March 20X8. This has not yet been accounted for.

Requirement

What profit or loss on disposal of Westville is reported in the Kingdom group accounts for the year ended 31 December 20X8?

Solution

Profit on disposal

	£	**£**
Proceeds		350,000
Less amounts recognised before disposal		
Net assets of Westville (£100,000 + £215,000 + (1/2 × £24,000) – £10,000)	317,000	
Goodwill (£280,000 + £67,000) – (£100,000 + £188,000)	59,000	
NCI at disposal		

	£	**£**
Share of net assets (20% × £317,000)	(63,400)	
Goodwill on acquisition (£67,000 – (20% × £288,000))	(9,400)	
		(303,200)
Profit on disposal		46,800

Consolidated statement of financial position

The statement of financial position does not include the subsidiary disposed of, as it is no longer controlled at the reporting date.

Consolidated statement of profit or loss and other comprehensive income

- The time-apportioned results of the subsidiary should be consolidated up to the date of disposal.
- The non-controlling interest must be time apportioned.
- The gain or loss on disposal forms part of the profit or loss for the year.

IFRS 5 discontinued operations

If the sale represents a **discontinued operation** per IFRS 5 the consolidated statement of profit or loss and other comprehensive income will reflect, **as one figure, 'Profit for the period from discontinued operations'**, being the group profit on disposal plus the subsidiary's profit for the year to disposal.

10.2.3 Group accounts – disposal of associate

In the **consolidated financial statements** the **profit or loss on disposal** should be calculated as:

	£	£
Proceeds		X
Less: cost of investment	X	
share of post-acquisition profits retained by associate at disposal	X	
impairment of investment to date	(X)	
		(X)
Profit/(loss)		X/(X)

The other effects of disposal are also similar to those of the disposal of a subsidiary:

- There is no holding in the associate at the end of the reporting period, so there is no investment to recognise in the consolidated statement of financial position.
- The associate's after-tax earnings should be included in consolidated profit or loss up to the date of disposal.

10.3 Part disposal from a subsidiary holding

10.3.1 Subsidiary to subsidiary

Shares may be disposed of such that a subsidiary holding is still retained eg, a 90% holding is reduced to a 70% holding.

In this case there is **no loss of control** and therefore:

- no gain or loss on disposal is calculated;
- no adjustment is made to the carrying value of goodwill; and
- the difference between the proceeds received and the change in the non-controlling interest is accounted for in shareholders' equity.

Consolidated statement of financial position

- Consolidate as normal with the NCI calculated by reference to the year-end shareholding.
- Calculate goodwill as at the original acquisition date.
- Record the difference between NCI and proceeds in shareholders' equity as above.

Consolidated statement of profit or loss and other comprehensive income

- Consolidate the subsidiary's results for the whole year.
- Calculate the NCI on a pro rata basis.

Worked example: Part disposal (subsidiary to subsidiary)

Express acquired 90% of Billings in 20X2 when Billings had retained earnings of £250,000. Goodwill was calculated as £45,000 using the proportion of net assets method to value the non-controlling interest. Goodwill has been impaired by £5,000 since acquisition.

At 31 December 20X8 the abbreviated statements of financial position of the two entities were as follows:

	Express	**Billings**
	£'000	**£'000**
Non-current assets	2,300	430
Investments	360	–
Current assets	1,750	220
	4,410	650
Share capital	1,000	100
Retained earnings b/f	1,190	304
Profit for the year	120	36
Liabilities	2,100	210
	4,410	650

Express disposed of a 10% holding in Billings on 31 August 20X8 for £70,000; this has not yet been recorded in Express's individual accounts.

Requirement

Prepare the consolidated statement of financial position as at 31 December 20X8.

Solution

Express Group statement of financial position at 31 December 20X8

	£'000
Non-current assets (£2,300,000 + £430,000)	2,730
Goodwill (£45,000 – £5,000)	40
Current assets (£1,750,000 + £220,000 + proceeds £70,000)	2,040
	4,810
Share capital	1,000
Retained earnings (W1)	1,412
Non-controlling interest 20% × (£650,000 – £210,000)	88
Liabilities (£2,100,000 + £210,000)	2,310
	4,810

WORKINGS

(1) **Retained earnings**

	£'000
Retained earnings of Express (£1,190,000 + £120,000) 1,310.0 Retained earnings of Billings	
Acquisition – 31 Aug 20X8 90% × (£304,000 + (8/12 × £36,000) –£250,000)	70.2
31 Aug 20X8 – 31 Dec 20X8 (80% × 4/12 × £36,000)	9.6
Impairment of goodwill	(5.0)
NCI adjustment on disposal (W2)	27.2
	1,412.0

(2) **NCI adjustment on disposal**

NCI in Billings at disposal:

	£'000
NCI at acquisition (10% × (100 + 250))	35.0
Share of post acqn. reserves (Working 3)	7.8
	42.8
Increase 10%/10%	42.8
NCI after disposal: 20%	85.6

At disposal date:	
NCI based on old shareholding (10% × £428,000)	42.8
NCI based on new shareholding (20% × £428,000)	85.6
Adjustment required	42.8

DEBIT	Proceeds	£70,000	
CREDIT	NCI		£42,800
CREDIT	Shareholders' equity (to Working 1)		£27,200

(3) **NCI share of post acqn. retained earnings**

	£'000
Retained earnings b/f (£304,000 – £250,000)	54.0
Profit to disposal (£36,000 × 8/12)	24.0
	78.0
NCI share 10%	7.8

10.3.2 Subsidiary to associate

Shares may be disposed of such that an associate holding is still retained, eg, a 90% holding is reduced to a 30% holding.

Gain or loss on disposal

In this case there is a loss of control, and so a gain or loss on disposal is calculated as:

	£	£
Proceeds		X
Fair value of interest retained		X
		X
Less net assets of subsidiary recognised before disposal:		
Net assets	X	
Goodwill	X	
Non-controlling interest	(X)	
		(X)
Profit/loss		X/(X)

Worked example: Part disposal (subsidiary to associate)

Allister Group acquired a 75% holding in Brown in 20X0, which it held until 31 December 20X8 when two-thirds of the investment were sold for £490,000.

At this date the net assets of Brown were £800,000, goodwill arising on acquisition had been fully impaired and the fair value of a 25% interest in Brown was £220,000.

The non-controlling interest is valued using the proportion of net assets method.

Requirement

What gain or loss arises on the disposal in the Allister Group accounts in the year ended 31 December 20X8?

Solution

Disposal

	£	£
Proceeds		490,000
Fair value of 25% interest retained		220,000
		710,000
Less amounts recognised before disposal:		
Net assets of Brown	800,000	
Goodwill (fully impaired)	-	
NCI at disposal (25% × £800,000)	(200,000)	
		(600,000)
Gain on disposal		110,000

Note: The disposal triggers remeasurement of the residual interest to fair value. The gain on disposal could be analysed as:

Realised gain	**£**	**£**
Proceeds on disposal	490,000	
Interest disposed of (50% × £800,000)	(400,000)	

Realised gain

	£	**£**
		90,000
Holding gain		
Retained interest at fair value	220,000	
Retained interest at carrying value (25% × £800,000)	(200,000)	
		20,000
Total gain		110,000

The retained 25% interest in Brown is included in the consolidated statement of financial position at 31 December 20X8 at the fair value of £220,000.

Consolidated statement of financial position

- Equity account by reference to the year-end holding. The carrying value of the associate is based on the fair value of the interest as included within the gain calculation.

Consolidated statement of profit or loss and other comprehensive income

- Consolidate results up to the date of disposal based on the pre-disposal holding
- Equity account for results after the date of disposal based on the post-disposal holding
- Include gain or loss on disposal as calculated above

Reclassification of other comprehensive income

At the date of disposal, amounts recognised in other comprehensive income in relation to the subsidiary should be accounted for in the same way as if the parent company had directly disposed of the assets that they relate to, for example, if the subsidiary holds revalued assets, the revaluation surplus previously recognised in consolidated other comprehensive income should be transferred to group retained earnings.

10.3.3 Subsidiary to investment

Shares may be disposed of such that an investment is still retained eg, a 90% holding is reduced to a 10% holding.

Gain or loss on disposal

The gain or loss on disposal is calculated as described in section 10.3.2. Therefore at the point of disposal, the retained interest is measured at fair value.

Statement of financial position

- The interest retained is initially recorded at fair value (as included within the gain calculation).

Statement of profit or loss and other comprehensive income

- Consolidate results up to the date of disposal based on the pre-disposal holding

- Include dividend income after the date of disposal
- Include gain or loss on disposal as calculated above

Reclassification of other comprehensive income

Upon loss of control, other comprehensive income recorded in relation to the subsidiary should again be accounted for in the same way as if the parent company had directly disposed of the assets that it relates to.

10.4 Part disposal from an associate holding

10.4.1 Associate to investment

Shares may be disposed of such that an investment is still retained eg, a 40% holding is reduced to a 10% holding.

Gain or loss on disposal

In this case there is a loss of significant influence, and a gain or loss on disposal is calculated as:

	£	£
Proceeds		X
Fair value of interest retained		X
		X
Less: Cost of investment	X	
Share of post-acquisition profits retained by associate at disposal	X	
Impairment of investment to date	(X)	
		(X)
Profit/(loss)		X/(X)

Statement of financial position

The interest retained is initially recorded at fair value (as included within the gain calculation).

Statement of profit or loss and other comprehensive income

- Equity account for results up to the date of disposal based on the pre-disposal holding
- Include dividend income after the date of disposal
- Include gain or loss on disposal as calculated above

Interactive question 8: All types of disposal

Streatham Co bought 80% of the share capital of Balham Co for £324,000 on 1 October 20X5. At that date Balham Co's retained earnings balance stood at £180,000. The statements of financial position at 30 September 20X8 and the summarised statements of profit or loss for the year to that date are given below:

	Streatham Co £'000	Balham Co £'000
Non-current assets	360	270
Investment in Balham Co	324	–
Current assets	370	370
	1,054	640

Equity		
Ordinary shares	540	180
Reserves	414	360
Current liabilities	100	100
	1,054	640
Profit before tax	153	126
Tax	(45)	(36)
Profit for the year	108	90

No entries have been made in the accounts for any of the following transactions. Assume that profits accrue evenly throughout the year.

It is the group's policy to value the non-controlling interests at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Ignore tax on the disposal.

Requirements

8.1 Prepare the consolidated statement of financial position and statement of profit or loss at 30 September 20X8 in each of the following circumstances. (Assume no impairment of goodwill.)

(a) Streatham Co sells its entire holding in Balham Co for £650,000 on 30 September 20X8.

(b) Streatham Co sells one-quarter of its holding in Balham Co for £160,000 on 30 September 20X8.

8.2 In the following circumstances you are required to calculate the gain on disposal, group retained earnings and carrying value of the retained investment at 30 September 20X8.

(a) Streatham Co sells one-half of its holding in Balham Co for £340,000 on 30 June 20X8, and the remaining holding (fair value £250,000) is to be dealt with as an associate.

(b) Streatham Co sells one-half of its holding in Balham Co for £340,000 on 30 June 20X8, and the remaining holding (fair value £250,000) is to be dealt with as a financial asset at fair value through other comprehensive income.

See **Answer** at the end of this chapter.

11 Consolidated statements of cash flows

Section overview

- The consolidated statement of cash flows shows the impact of the acquisition and disposal of subsidiaries and associates.
- Exchange differences arising on the translation of the foreign currency accounts of group companies will also impact the consolidated statement of cash flows. This is covered in more detail in later Chapters.
- Both single company and consolidated statements of cash flow were covered at Professional Level. Single company statements were revisited in earlier Chapters of this Workbook. In this chapter we summarise the main points and provide two interactive questions and two

comprehensive self- test questions. Please look back to your earlier study material if you have any major problems with these.

11.1 Consolidated statements of cash flows – revision

You should remember from your Professional Level studies that the consolidated statement of cash flows is put together from the consolidated financial statements themselves. Additional figures over and above a single company statement of cash flows will be as follows:

- Dividends paid to the non-controlling interest
- Dividend received from associates and joint ventures
- Acquisitions/disposals of subsidiaries
- Acquisitions/disposals of associates and joint ventures

11.1.1 Cash flows to the non-controlling interest

The non-controlling interest represents a third party so **dividends paid to the non-controlling interest are reflected as a cash outflow.** This payment should be presented separately and classified as '**Cash flows from financing activities**'.

Dividends paid to the non-controlling interest may be calculated using a T-account as follows:

NON-CONTROLLING INTEREST

	£		£
		b/f NCI (CSFP)	X
		NCI (CIS)	X
NCI dividend paid (balancing figure)			
c/f NCI (CSFP)	**X** X X		
			X

11.1.2 Associates and joint ventures

There are two issues to consider with regard to the associate/joint venture. (Note that joint ventures are treated like associates in that they are equity accounted, so the points below apply to both.)

(a) The aim of the statement of cash flows is to show the cash flows of the parent and any subsidiaries with third parties, therefore **any cash flows between the associate and third parties are irrelevant.** As a result, **the group share of profit of the associate must be deducted as an adjustment in the reconciliation of profit before tax to cash generated from operations**. This is because group profit before tax includes the results of the associate.

(b) **Dividends received** from the associate must be disclosed as a **separate cash flow** classified as

'Cash flows from investing activities'. The cash receipt can be calculated as follows:

INVESTMENTS IN ASSOCIATES

	£		£
		b/f NCI (CSFP)	X
		NCI (CIS)	X
NCI dividend paid (balancing figure)	**X**		
c/f NCI (CSFP)	X		
	X		X

11.1.3 Acquisitions and disposals of subsidiaries

If a subsidiary is acquired or disposed of during the accounting period **the net cash effect of the purchase or sale transaction should be shown separately under 'Cash flows from investing activities'**. The net cash effect will be the cash purchase price/cash disposal proceeds net of any cash or cash equivalents acquired or disposed of.

As the cash effect of the acquisition/disposal of the subsidiary is dealt with in a single line item as we saw above, **care must be taken not to double count the effects of the acquisition/disposal when looking at the movements in individual asset balances**.

Each of the individual assets and liabilities of a subsidiary acquired/disposed of during the period must be excluded when comparing group statements of financial position for cash flow calculations as follows:

Subsidiary acquired in the period	**Subtract** PPE, inventories, payables, receivables etc, at the date of acquisition from the movement on these items.
Subsidiary disposed of in the period	**Add** PPE, inventories, payables, receivables etc, at the date of disposal to the movements on these items.

This would also affect the calculation of the **dividend paid to the non-controlling interest**. The T- account working is modified as follows:

NON-CONTROLLING INTEREST

	£ X		£
NCI in Subsidiary at disposal		b/f NCI (CSFP)	X
NCI dividend paid (balancing figure)	X X X	**NCI in Subsidiary at acquisition**	**X**
c/f NCI (CSFP)		NCI (CIS)	X
			X

11.1.4 Acquisitions and disposals of associates

If an **associate is acquired or disposed of** during the accounting period the payment or receipt of cash is classified as investing activities.

Interactive question 9: Acquisition of a subsidiary

On 1 October 20X8 Pippa plc acquired 90% of S Ltd by issuing 100,000 shares at an agreed value of £2 per share and paying £100,000 in cash.

At that time the net assets of S Ltd were as follows:

	£'000
Property, plant and equipment	190
Inventories	70
Trade receivables	30
Cash and cash equivalents	10
Trade payables	(40)
	260

The consolidated statements of financial position of Pippa plc as at 31 December were as follows:

	20X8 £'000	20X7 £'000
Non-current assets		
Property, plant and equipment	2,500	2,300
Goodwill	66	
	2,566	2,300
Current assets		
Inventories	1,450	1,200
Trade receivables	1,370	1,100
Cash and cash equivalents	76	50
	2,896	2,350
	5,462	4,650
Equity attributable to owners of the parent		
Ordinary share capital (£1 shares)	1,150	1,000
Share premium account	650	500
	20X8 £'000	20X7 £'000
Retained earnings	1,791	1,530
	3,591	3,030
Non-controlling interest	31	
Total equity		3,030
	3,622	
Current liabilities		
Trade payables	1,690	1,520
Income tax payable	150	100
	1,840	1,620
	5,462	4,650

The consolidated statement of profit or loss for the year ended 31 December 20X8 was as follows:

	£'000
Revenue	10,000
Cost of sales	(7,500)
Gross profit	2,500
Administrative expenses	(2,080)
Profit before tax	420
Income tax expense	(150)
Profit for the year	270
Profit attributable to:	
Owners of Pippa plc	261
Non-controlling interest	9
	270

The statement of changes in equity for the year ended 31 December 20X8 (extract) was as follows:

	Retained earnings
	£'000
Balance at 31 December 20X7	1,530
Total comprehensive income for the year	261
Balance at 31 December 20X8	1,791

You are also given the following information:

(1) All other subsidiaries are wholly owned.

(2) Depreciation charged to the consolidated statement of profit or loss amounted to £210,000.

(3) There were no disposals of property, plant and equipment during the year.

(4) Goodwill is not impaired.

(5) Non-controlling interest is valued on the proportionate basis.

Requirement

Prepare a consolidated statement of cash flows for Pippa plc for the year ended 31 December 20X8 under the indirect method in accordance with IAS 7, *Statement of Cash Flows*. The only notes required are those reconciling profit before tax to cash generated from operations and a note showing the effect of the subsidiary acquired in the period.

See **Answer** at the end of this chapter.

Interactive question 10: Disposal

Below is the consolidated statement of financial position of the Caitlin Group as at 30 June 20X8 and the consolidated statement of profit or loss for the year ended on that date:

Consolidated statement of financial position as at 30 June

	20X8	20X7
	£'000	£'000
Non-current assets		
Property, plant and equipment	4,067	3,950
Current assets		
Inventories	736	535
Receivables	605	417
Cash and cash equivalents	294	238
	1,635	1,190
	5,702	5,140
Equity attributable to owners of the parent		
Share capital	1,000	1,000
Retained earnings	3,637	3,118
	4,637	4,118
Non-controlling interest	482	512
Total equity	5,119	4,630
Current liabilities		
Trade payables	380	408
Income tax payable	203	102
	583	510
	5,702	5,140

Consolidated statement of profit or loss for the year ended 30 June 20X8 (summarised)

	£'000
Continuing operations	
Profit before tax	862
Income tax expense	(290)
Profit for the year from continuing operations	572

	£'000
Discontinued operations	
Profit for the year from discontinued operations	50
Profit for the year	622
Profit attributable to:	
Owners of Caitlin plc	519
Non-controlling interest	103
	622

You are given the following information:

(1) Caitlin plc sold its entire interest in Desdemona Ltd on 31 March 20X8 for cash of £400,000. Caitlin plc had acquired an 80% interest in Desdemona Ltd on incorporation several years ago. The net assets at the date of disposal were:

	£'000
Property, plant and equipment	390
Inventories	50
Receivables	39
Cash and cash equivalents	20
Trade payables	(42)
	457

(2) The profit for the period from discontinued operations figure is made up as follows:

	£'000
Profit before tax	20
Income tax expense	(4)
Profit on disposal	34
	50

(3) The depreciation charge for the year was £800,000.

There were no disposals of non-current assets other than on the disposal of the subsidiary.

Requirements

With regard to the consolidated statement of cash flows for the year ended 30 June 20X8:

(a) Show how the disposal will be reflected in the statement of cash flows.

(b) Calculate additions to property, plant and equipment as they will be reflected in the statement of cash flows.

(c) Calculate dividends paid to the non-controlling interest.

(d) Prepare the note to the statement of cash flows required for the disposal of the subsidiary.

(e) Prepare the reconciliation of profit before tax to cash generated from operations.

Note: Work to the nearest £'000.

See **Answer** at the end of this chapter.

12 Audit focus: group audits

Section overview

- The group auditor has sole responsibility for the audit opinion on the group financial statements.
- The component auditors should co-operate with the group auditors. In some cases this will be a legal duty.
- The group auditor will need to assess the extent to which the work of the component auditors can be relied on.
- Specific audit procedures will be performed on the consolidation process.
- Where a group includes a foreign subsidiary, compliance with relevant accounting standards will need to be considered.

12.1 Introduction

Many of the basic principles applied in the audit of a group are much the same as the audit of a single company. However, there are a number of significant **additional considerations**.

The first area to consider is the use of another auditor. Often, one or more subsidiaries in the group will be audited by a different audit firm. Evaluating whether the component auditor's work can be relied on, and communicating effectively with the component auditor, therefore become important.

Another of the key issues will be the impact of the group structure on the **risk assessment**, including the process by which the existing structure has been achieved eg, acquisition and MBO, and/or changes to that structure. In many cases, the risk issues will be related to the accounting treatments adopted.

12.2 Acceptance as group auditors

ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* is the relevant standard.

ISA 600.12 states that the auditor must consider whether "sufficient appropriate audit evidence can reasonably be expected to be obtained in relation to the consolidation process and the financial information of the components on which to base the group audit opinion". For this purpose, the group engagement partner must obtain an understanding of the group. This may be obtained from the following sources.

In the case of **a new engagement**:

- Information provided by group management
- Communication with group management
- Where applicable, communication with the previous group engagement team, component manager or component auditors

Other matters to consider will include the following:

- The group structure
- Components' business activities including the industry and regulatory, economic and political environments in which those activities take place
- The use of service organisations

- A description of group-wide controls
- The complexity of the consolidation process
- Whether component auditors that are not from the group engagement partner's firm will perform work on the financial information of any of the components and group management's rationale for appointing more than one auditor
- Whether the group engagement team will have unrestricted access to those charged with governance of the group, group management, those charged with governance of the component, component management, component information and the component auditors (including relevant audit documentation sought by the group engagement team)
- Whether the group engagement team will be able to perform necessary work on the financial information of the components

(ISA 600.A10–.A11)

In the case of **continuing engagements**, the group engagement team's ability to obtain sufficient appropriate audit evidence may be affected by **significant changes**, for example changes in group structure, changes to group-wide controls or the applicable financial reporting framework, changes in business activities and concerns regarding the integrity and competence of group or component management.

(ISA 600.A12)

Where components within the group are likely to be **significant components** the group engagement partner evaluates the extent to which the group engagement team will be able to be involved in the work of those component auditors.

The group engagement partner must either refuse to accept, or resign from, the engagement if he concludes that it will not be possible to obtain sufficient appropriate audit evidence.

(ISA 600.12-.13)

Note: In addition to these points, the prospective group auditor should consider the general points relating to acceptance of appointment which you have covered in Professional level.

12.3 Using the work of another auditor

We have identified the fact that entities within the group may be audited by different auditors as a risk factor. Guidance on this aspect of the group audit is provided in ISA 600. Subsidiaries may be audited by firms other than the parent company auditor, meaning that the parent company auditor will have to express an opinion on financial information, some of which has been audited **by another party**. ISA 600 addresses this issue in particular and is summarised below.

12.3.1 Responsibility of group auditors

Definitions

Group audit: The audit of the group financial statements.

Group engagement partner: The partner or other person in the firm who is responsible for the group audit engagement and its performance and for the auditor's report on the group financial statements that is issued on behalf of the firm.

Group engagement team: Partners, including the group engagement partner, and staff who establish the overall group audit strategy, communicate with component auditors, perform work on the consolidation process, and evaluate the conclusions drawn from the audit evidence as the basis for forming an opinion on the group financial statements.

Component auditor: An auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

Component: An entity or business activity for which the group or component management prepares financial information that should be included in the group financial statements.

Component materiality: The materiality for a component determined by the group engagement team.

Significant component: A component identified by the group engagement team: (a) that is of individual significance to the group, or (b) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements.

(ISA 600.9)

The duty of the group auditors is to report on the **group accounts**, which includes balances and transactions of all the components of the group.

The group auditors have **sole responsibility** for this opinion even where the group financial statements include amounts derived from accounts which have not been audited by them. ISA 600 explains that even where an auditor is required by law or regulation to refer to the component auditors in the auditor's report on the group financial statements, the report must indicate that the reference does not diminish the group engagement partner's or the firm's responsibility for the group audit opinion. As a result, they cannot discharge their responsibility to report on the group financial statements by an unquestioning acceptance of component companies' financial statements, whether audited or not.

(ISA 600.11)

Note: For audits of group financial statements of PIEs the group engagement partner is also responsible for the additional report to the audit committee as required by ISA 260 (Revised) (ISA 600.49).

12.3.2 Rights of group auditors

The group auditors of a parent company have the following rights:

- The right to require the information and explanations they require from auditors of subsidiaries
- The right to require the parent company to take all reasonable steps to obtain reasonable information and explanations from foreign subsidiaries

These rights are addressed in ISA 600 by para.19 the group engagement team shall request the agreement of the component auditor to the transfer of relevant documentation during the conduct of the group audit, a condition of the use by the group engagement team of the work of the component auditor.

Note: The group auditors also have all rights and powers in respect of their audit of the parent company that you should be familiar with from Professional Level for example, right of access at all times to the parent company's books, accounts and vouchers.

12.4 Planning and risk assessment as group auditor

The planning and risk assessment process will need to take into account the fact that all elements of the group financial statements are not audited by the group auditor directly. The group auditor will not be able to simply rely on the conclusions of the component auditor. ISA 600 requires the group auditor to evaluate the reliability of the component auditor and the work performed. This will then determine the extent of further procedures.

Understanding the component auditor

This involves an assessment of the following:

(a) Whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit and, in particular, is independent

(b) The component auditor's **professional competence**

(c) Whether the group engagement team will be able to be **involved in the work of the component auditor** to the extent necessary to obtain sufficient appropriate audit evidence

(d) Whether the component auditor operates in a **regulatory environment** that actively oversees auditors

(ISA 600.19)

The group engagement team's understanding of the component auditor's professional competence may include considering whether the component auditor:

- possesses an understanding of auditing and other standards applicable to the group audit;
- has sufficient resources to perform the work;
- possesses the special skills necessary to perform the work; and
- where relevant, possesses an understanding of the applicable financial reporting framework.

(ISA 600.A38)

The group engagement team may obtain this understanding in a number of ways. In the first year, for example, the component auditor may be visited to discuss these issues. Alternatively, the component auditor may be asked to confirm these matters in writing or to complete a questionnaire.

Confirmations from professional bodies may also be sought and the reputation of the firm will be taken into account.

Materiality

The group auditor is responsible for setting the materiality level for the group financial statements as a whole. Materiality levels should also be set for components which are individually significant. These should be set at a lower level than the materiality level of the group as a whole.

(ISA 600.21)

Extent of work required on components

The ISA distinguishes between **significant components** and other components which are not individually significant to the group financial statements.

The group auditor should be involved in the assessment of risk in relation to significant components.

If a component is financially significant to the group financial statements then the group engagement team or a component auditor will perform a full audit based on the component materiality level.

If the component is likely to include significant risks of material misstatement of the group financial statements due to its nature or circumstances, the group auditors will require one of the following:

- A full audit using component materiality
- An audit of specified account balances related to identified significant risks
- Specified audit procedures relating to identified significant risks

(ISA 600.27)

Components that are not significant components will be subject to analytical review at a group level.

(ISA 600.28)

If the group engagement team does not consider that sufficient appropriate audit evidence on which to base the group audit opinion will be obtained from the work performed on significant components, on group-wide controls and the consolidation process and the analytical procedures performed at group level, then some components that are not significant components will be selected and one or more of the following will be performed (either by the group auditor or the component auditor):

- An audit using component materiality
- An audit of one or more account balances, classes of transactions or disclosures
- A review using component materiality
- Specified procedures

(ISA 600.29)

Involvement in the work of a component auditor

The extent of involvement by the group auditor at the planning stage will depend on the:

- significance of the component;
- identified significant risks of material misstatement of the group financial statements; and
- group auditor's understanding of the component auditor.

Based on these factors the group auditors may perform the following procedures:

(a) Meeting with the component management or the component auditors to obtain an understanding of the component and its environment

(b) Reviewing the component auditor's overall audit strategy and audit plan

(c) Performing risk assessment procedures to identify and assess risks of material misstatement at the component level. These may be performed with the component auditor or by the group auditor

Where the component is a **significant component** the nature, timing and extent of the group auditor's involvement is affected by their understanding of the component auditor but at a minimum should include the following procedures:

(a) Discussion with the component auditor or component management regarding the component's business activities that are significant to the group

(b) Discussing with the component auditor the susceptibility of the component to material misstatement of the financial information due to fraud or error

(c) Reviewing the component auditor's documentation of identified significant risks of material misstatements. This may be in the form of a memorandum including the conclusions drawn by the component auditors

12.4.1 Evaluating the work of the component auditor

(ISA 600.30)

For all companies in the group, the group auditor is required to perform a review of the work done by the component auditor (ISA 600.42). This is normally achieved by reviewing a report or questionnaire completed by the component auditor which highlights the key issues which have been identified during the course of the audit. The effect of any uncorrected misstatements and any instances where there has been an inability to obtain sufficient appropriate audit evidence should also be evaluated. On the basis of this review the group auditor then needs to determine whether any additional procedures are necessary. These may include the following:

- Designing and performing further audit procedures. These may be designed and performed with the component auditors, or by the group auditor

- Participating in the closing and other key meetings between the component auditors and component management
- Reviewing other relevant parts of the component auditors' documentation

12.4.2 Communication

The group engagement team shall communicate its requirements to the component auditor on a timely basis (ISA 600.40).

ISA 600 prescribes the types of information that must be sent by the group auditor to the component auditor and vice versa.

The group auditor must set out for the component auditor the work to be performed, the use to be made of that work and the form and content of the component auditor's communication with the group engagement team. According to para A35 of ISA 600 this includes the following:

- A request that the component auditor **confirms their cooperation** with the group engagement team.
- The **ethical requirements** that are relevant to the group audit and in particular independence requirements.
- In the case of an audit or review of the financial information of the component, **component materiality** and the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements.
- Identified **significant risks** of material misstatement of the group financial statements, due to fraud or error that are relevant to the work of the component auditor. The group engagement team requests the component auditor to communicate any other identified significant risks of material misstatement and the component auditor's responses to such risks.
- A list of **related parties** prepared by group management and any other related parties of which the group engagement team is aware. Component auditors are requested to communicate any other related parties not previously identified.

In addition to the above, the group auditor must ask the component auditor to communicate matters relevant to the group engagement team's conclusion with regard to the group audit. These include the following:

(a) Whether the component auditor has complied with **ethical requirements** that are relevant to the group audit, including independence and professional competence

(b) Whether the component auditor has complied with the **group engagement team's requirements**

(c) Identification of the **financial information** of the component on which the component auditor is reporting

(d) Information on instances of **non-compliance with laws and regulations** that could give rise to material misstatement of the group financial statements

(e) A list of **uncorrected misstatements** of the financial information of the component (the list need not include items that are below the threshold for clearly trivial misstatements)

(f) Indicators of **possible management bias**

(g) Description of any identified **significant deficiencies in internal control** at the component level

(h) **Other significant matters** that the component auditor communicated or expects to communicate to those charged with governance of the component, including fraud or suspected fraud involving component management, employees who have significant roles in internal control at the component level or others where the fraud resulted in a material misstatement of the financial information of the component

(i) **Any other matters** that may be relevant to the group audit or that the component auditor wishes to draw to the attention of the group engagement team, including exceptions noted in the written representations that the component auditor requested from component management

(j) The component auditor's **overall finding, conclusions or opinion**

This communication often takes the form of a **memorandum or report of work performed**.

12.4.3 Communicating with group management and those charged with governance

ISA 600 states that the group engagement team will determine which of the identified deficiencies in internal control should be communicated to those charged with governance and group management. In making this assessment the following matters should be considered.

- Significant deficiencies in the design or operating effectiveness of group-wide controls
- Deficiencies that the group engagement team has identified in internal controls at components that are judged to be significant to the group
- Deficiencies that component auditors have identified in internal controls at components that are judged to be significant to the group
- Fraud identified by the group engagement team or component auditors or information indicating that a fraud may exist

(ISA 600.46-.47)

Where a component auditor is required to express an audit opinion on the financial statements of a component, the group engagement team will request group management to inform component management of any matters that they, the group engagement team, have become aware of that may be significant to the financial statements of the component. If group management refuses to pass on the communication, the group engagement team will discuss the matter with those charged with governance of the group. If the matter is still unresolved the group engagement team shall consider whether to advise the component auditor not to issue the audit report on the component financial statements until the matter is resolved.

12.4.4 Communication with those charged with governance of the group

(ISA 600.48)

The following matters should be communicated to those charged with governance of the group:

(a) An overview of the type of work to be performed on the financial statements of the component

(b) An overview of the nature of the group engagement team's planned involvement in the work to be performed by the component auditors on significant components

(c) Instances where the group engagement team's evaluation of the work of a component auditor gave rise to a concern about the quality of that auditor's work

(d) Any limitations on the group audit, for example, where the group engagement team's access to information may have been restricted

(e) Fraud or suspected fraud involving group management, component management, employees who have significant roles in group-wide controls or others where fraud resulted in a material misstatement of the group financial statements

12.4.5 Documentation

(ISA 600.49)

The group engagement team must include in the audit documentation the following matters:

- An analysis of components, indicating those that are significant

- The nature, timing and extent of the group engagement team's involvement in the work performed by the component auditors on significant components including, where applicable, the group engagement team's review of the component auditor's audit documentation
- Written communications between the group engagement team and the component auditors about the group engagement team's requirements

In the UK, the Companies Act 2006 requires group auditors to review the audit work conducted by other persons and to record that review. This requirement is now also specifically addressed in the revised ISA.

(ISA 600.50)

Interactive question 11: Component auditors

You are the main auditor of Mouldings Holdings, a listed company, which has subsidiaries in the country and overseas, many of which are audited by other firms. All subsidiaries are involved in the manufacture or distribution of plastic goods and have accounting periods coterminous with that of the parent company.

Requirements

11.1 State why you would wish to review the work of the auditors of the subsidiaries not audited by you.

11.2 Describe the key audit procedures you would carry out in performing such a review. See

Answer at the end of this chapter.

12.5 Risk assessment procedures

12.5.1 General accounting issues

Consolidated financial statements give rise to additional audit risks:

- Are **consolidated group accounts** correctly prepared?
- Where there have been any **disposals** of material business segments, have the requirements of IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations* been satisfied?
- Have adequate **disclosures** of significant investments and financing been made?
- Where there have been acquisitions during the year, have **new assets and liabilities** been correctly brought into the financial statements?
- Where there have been acquisitions during the year, has **purchase consideration** been correctly accounted for and disclosed?
- Have **foreign taxes** (including corporate tax, income taxes for employees and capital gains tax) been accounted for correctly?
- Have transfer pricing issues around **intercompany transactions,** and their VAT impact, been considered?

12.5.2 Acquisition

Acquisitions can take many forms. The type of acquisition (eg, hostile, friendly) and future management of the subsidiary (fully integrated, autonomous) will also impact on risk.

Risk areas	Key issues
Valuation of assets and liabilities	These should be valued at **fair value** at the date of acquisition in accordance with IFRS 13.
Valuation of consideration	This should be at **fair value** and will include any **contingent consideration**. Any **deferred consideration** should be discounted.
Goodwill	This must be calculated and accounted for in accordance with IFRS 3.
Date of control	The results of any subsidiary should only be accounted for from the **date of acquisition**.
Level of control or influence	This will determine the nature of the investment and its subsequent treatment in the group financial statements eg, subsidiary, associate and should be determined in accordance with IFRS 10/IAS 28 (IFRS 10 retains control as the key concept underlying the parent/subsidiary relationship but has broadened the definition and clarified the application).
Accounting policies/reporting periods	Accounting policies and reporting periods must be **consistent** across the group.
Consolidation adjustments	The group must have **systems** which enable the **identification** of intra-group balances and accounts.
Adequacy of provisions in the target company	While the acquirer is likely to know its plans, **other provisions** may be necessary within the acquired entity. If such provisions are currently unrecognised and have never been recorded (eg, in board minutes), there is a clear risk that the acquiring entity will overpay.
Use of provisions to manipulate post- acquisition profits	Provisions may be recognised at the point of acquisition and then **released at some point in the future** in order to make post-change results appear impressive. This may imply that change was a correct business decision. The use of such provisions has been reduced by IAS 37.

12.5.3 Divestment and withdrawal

The withdrawal from a market will give rise to several audit issues:

Obsolete inventory

Inventory which is no longer required will need to be written down. When carrying out the inventory count, the auditor will need to ensure that all inventory relating to the discontinued activity is identified. The following procedures should take place.

- **Discussions with management** concerning net realisable value of inventory
- **Investigation of future costs** relating to any modifications needed for the inventory
- **Review of after-date sales** to assess likelihood of sale and sale proceeds

Obsolete non-current assets

If an operation has been withdrawn from, rather than sold as, a business segment, it is likely that some non-current assets such as plant and machinery and property will remain with the company. The following will need to be considered.

(a) **Net realisable value** of non-current assets (review of post year end sales invoices/review of trade magazines)

(b) **Write-down** of non-current assets to recoverable amount, surplus property to the market value

(c) **Impairment reviews** will need to be performed. This is likely to consider the remaining assets as one cash generating unit; lack of future revenue from this unit is likely to result in the assets being valued at their net realisable value (ie, fair value less costs of disposal) rather than their value in use

Disposal of investments

Disposal of a subsidiary, or other investment, will need to be accounted for in the group and parent company financial statements.

The auditor will need to ascertain the **date of disposal**, through inspection of sale agreements, to identify the correct period of allocation to the accounts.

(a) **Parent company** – The auditor will need to compare the sale proceeds (inspection of sale agreements/bank receipts) with the carrying amount of the investment in the statement of financial position to ensure that the correct profit or loss on disposal is accounted for.

(b) **Group accounts** – The auditor would need to ensure that the investment is not included in the year-end statement of financial position (unless some shareholding remains). Amounts in the statement of profit or loss and other comprehensive income should be pro-rated for the number of months held.

Chargeable gains and corporation tax

The disposal of a subsidiary or other investment is likely to have chargeable gains tax and corporation tax implications. These include:

(a) **Chargeable gains on disposal** – Chargeable gains or losses will arise on the disposal of subsidiaries or other investments. The auditor will need to discuss with management and inspect the sale agreement, in order to understand which party will bear the tax liability arising from chargeable gains. Where the tax liability falls on the seller, the chargeable gains tax calculations must be reviewed, and the utilisation of losses or tax relief verified. This should be done by a tax specialist if the matter is material.

(b) **Degrouping charges** – Degrouping charges will arise if any assets have previously been transferred to the subsidiary being sold at no gain/no loss. If the amount is material, the workings should be reviewed and recalculated.

(c) **Intra-group balances** – Existing loans and other outstanding balances with group companies may be written off when subsidiaries are disposed of or liquidated. The availability of corporation tax deductions on intercompany loan write-offs can be a complex issue and often constitutes a material matter. The corporation tax calculations should therefore be reviewed by a tax accounting specialist.

12.5.4 Joint arrangements

The example below illustrates some of the risk factors the auditor needs to consider in relation to joint arrangements.

Worked example: Joint arrangements

The Royal Bank of Edinburgh (RBE) has entered into several joint arrangements:

(1) "Ecost Personal Finance has made excellent progress since it was launched 18 months ago. To date, it has acquired over 700,000 customers.

In a relatively short time, in partnership with Ecost, we have established a significant and innovative new force in UK banking. We remain very optimistic about the prospects for Ecost Personal Finance and our expectations remain that this business will move into profit in the near future.

(2) We have also received an encouraging response to the Branson One Account through our collaboration with Branson Direct Personal Financial Services."

Requirement

Examine the risk factors associated with the Royal Bank of Edinburgh joint arrangements.

Solution Costs

The set-up costs of the two ventures will need financing. Will this be done from the existing funds
within the companies, or will external finance be needed?

As RBE is a financial institution, is it providing the bulk of the finance with loan amount outstanding to the other parties?

How will the infrastructure be established? Who will pay for the website to be constructed and maintained? What is the split of these costs?

What is the profit forecast for the first periods? Initial expenses are likely to exceed revenues, therefore losses may be expected in the initial periods.

Accounting

RBE is already established in this market and is therefore likely to be providing the asset base to support its activities. How are the assets valued in the joint venture accounts?

Is there any payment to be made to RBE for the knowledge and experience that it brings to the joint arrangements?

What type of joint arrangement is it?

What is the agreement on profit sharing? The underlying elements will need to be audited and the profit share recalculated. The tax liability arising from RBE's share of the profits also needs to be audited.

How long is the joint arrangement agreement for? This will help ascertain the correct write-off period of assets.

If either of the joint arrangements is loss making, has consortium relief been assumed in RBE's accounts? Has this been correctly calculated?

Markets

The products are likely to be launched through the internet; this may expand the customer base of the companies. E-business has its own specific set of risks; these are covered in the Business Strategy section of Business Environment.

People

It is likely that there will be a combination of staff involved from each of the parties, plus some additional staff new to both organisations. The cultural and operational impacts (as explained in the main text) need to be considered.

Systems

If the arrangements described are joint ventures, a completely new set of systems will need to be established. Risk will be increased due to the unfamiliarity of the staff with these systems.

Responsibility for control

If the entity is a limited company then the directors will be responsible for ensuring proper controls.

12.5.5 Management buy-outs

Whether it is a management buy-out (MBO), a management buy-in (MBI) or a combination of the two (BIMBO), the most pressing risk is that one party is likely to have a **comparative advantage** on detailed financial information. In this respect, the current management team of a business have a major advantage over existing shareholders, interested investors/buyers and providers of finance.

For example, in an MBI where the outgoing management team own stakes in the entity, there is an inherent danger of overstating the value of the organisation. In an MBO, it may work both ways, with the MBO team looking for as low a price as possible, but also needing to convince outside providers of finance to invest.

In a BIMBO, the situation becomes even more complicated, with the existing management team looking to convince the additional management team that prospects are good in order to conclude the deal, while knowing that once the deal is finalised the two groups will have to work in tandem.

In addition to the above issues, an existing management team may find its role changing from manager to owner/manager, introducing new risks (conflict of interest, bias in preparing financial information etc).

In any buy-out scenario, both **historical and future financial information** will play a key role. **Consistency** must exist between accounting treatments in both past and future data to ensure **comparability**.

Historical data is likely to suffer from the problem that the audit was not designed with a business valuation in mind. Future data presents a more obvious problem for auditors and accountants, in that there is full knowledge of the reasons for preparation and, as such, liability for error and omission is clearer. The level of assurance, and therefore the level of detail of the assurance work, will necessarily be greater than for a statutory audit.

As a result of these issues, the external parties in a buy-out situation are likely to take **independent assurance advice**, rather than reliance being placed on the work of the company's usual auditors or accountants. While any deal remains incomplete, privacy is likely to ensure that external parties have to rely on complete and accurate information being presented. The **due diligence** exercise (see Chapter 25) provides a detailed verification, normally after the deal is complete, that the information relied upon was correct.

The greater the level of assurance that can be achieved, the easier it is likely to be to raise finance, whatever the source. The cost of finance may also be reduced if the assurance achieved is considered reliable. For this reason, many organisations will pay relatively high professional fees to the largest and most renowned firms of accountants and advisers.

While the initial investment in fees is high, the returns (greater probability of finance and at a lower cost) can easily make the decision valid.

12.6 Audit procedures

The diagram below summarises the key points in the context of the group audit.

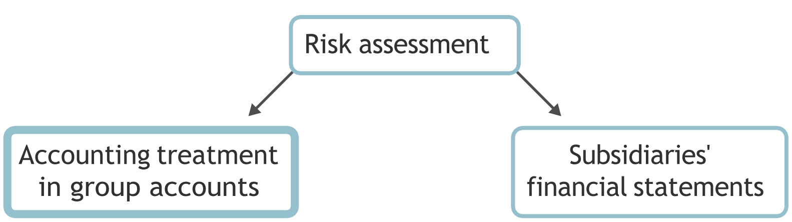


Figure 20.4: Audit procedures

CHAPTER 20

Potential misstatement in group accounts due to	Factors affecting risk of material misstatement in subsidiary financial statements
• Misclassification of investments (subsidiary vs associate vs financial asset) • Inappropriate inclusion, or exclusion from, consolidation or incorrect treatment of excluded subsidiaries • Inappropriate consolidation method • Inappropriate translation method for overseas subsidiaries • Incorrect consolidation adjustments eg, failure to eliminate intra-group items properly eg, leading to potential overstatements of assets and profits • Inconsistent accounting policies for amounts included in consolidation • Incorrect calculation (fair values) or treatment of goodwill • Incorrect calculation of profit/loss on disposal or classification of results of subsidiaries disposed of (continuing vs discontinued) • Incorrect determination of date of acquisition • Deferred or contingent consideration; step acquisition	• Scope of component auditors' work (may not provide sufficient appropriate evidence that financial statements are free from material misstatement) • Past audit problems • Anticipated changes • Materiality • Sufficiency of evidence to confirm amounts • Overseas subsidiaries • Non-coterminous year ends • Existence of letter of comfort

12.6.1 Acquisition

If the group audit includes a **newly acquired subsidiary** or a subsidiary which is disposed of, compliance with IFRS 3 and IFRS 10 will be relevant. The auditor will need to consider the following issues in particular:

Issue	Audit consequence
Level of control	The auditor will need to consider whether the **appropriate accounting treatment** has been adopted depending on the level of control (per IFRS 10 an investor controls an investee if it has power over the investee, exposure or rights to variable returns and the ability to use power to affect returns). Procedures will be as follows: • Identify total number of shares held to calculate % holding. • Review contract or agreements between companies to identify key terms which may indicate control and any restriction on control eg, right of veto of third parties.
Date of control/change in stake	The auditor should: • Review **purchase agreement** to identify date of control. • Ensure consolidation has occurred from **date control achieved**. • Review consolidation schedules to ensure amounts have been **time apportioned** if appropriate.

Issue	Audit consequence
Valuation of assets and liabilities at fair value	A review will need to be carried out of the **fair value** of assets and liabilities at the date of acquisition, adjusted to the year end (in accordance with IFRS 13). Review of trade journals or specialist valuations may be required. Where specialist valuers have been used (eg, to value brands) an assessment will need to be made on the reliability of these valuations. Where **intangibles have been recognised on consolidation** which were not previously recognised in the individual financial statements of the company acquired the auditor will need to give careful consideration as to the justification of this and whether the treatment is in accordance with IFRS 3/IFRS 13. Estimates for provisions existing at the date of acquisition will need to be **assessed for reliability**.
Valuation of consideration	**Contingent consideration** should be included as part of the consideration transferred. It must be measured at fair value at the acquisition date. The **discount rate** used to discount deferred consideration should be validated.
Goodwill	The auditor will need to consider whether the initial calculation is correct in accordance with IFRS 3. Performance of the subsidiary company will need to be reviewed to identify whether any **impairment** is necessary.
Tax liabilities and assets	The amount of corporation tax liabilities provided for will need to be reviewed. Deferred tax assets and liabilities must also be reviewed. The impairment of assets or goodwill should be taken into account.
Prior year audit of subsidiary	As first year of inclusion of subsidiary, review last year's audit report for any **modification** and consider implications for this year's audit if necessary.
Planning issues	**Adjust audit plan** to ensure visit to subsidiary is included. If audited by another auditor contact secondary auditor to discuss the following: • Audit deadline • Type and quality of audit papers • Review of audit • Identification of consolidation adjustments

12.6.2 Disposal

Where the group includes a subsidiary which has been disposed of during the year, the following issues will be relevant:

- Identification of the **date of the change** in stake
- Assessment of the **remaining stake** to determine the appropriate accounting treatment post- disposal
- Assessment of the **fair value of the remaining stake**
- Whether the **profit or loss on disposal** has been calculated in accordance with IFRS Standards
- Whether amounts have been appropriately **time apportioned** eg, income and expense items

12.6.3 Auditing an ongoing group of companies

Certain issues will be relevant to the auditor each year **irrespective of whether there is any change in the structure of the group**. In particular, the auditor will need to ensure that IFRS 10 has been complied with. The following will be relevant.

Issue	Audit consequence
Accounting policies/reporting period	Identify subsidiary's **accounting policies** from review of financial statements, compare to parent company's and adjust for consistency where necessary. Further adjustments may be required if some group companies prepare financial statements in accordance with **IFRS Standards**. Ensure that subsidiary's reporting period is **consistent** with the parent company's or that interim accounts have been prepared where necessary. (If not possible subsidiary's accounts may still be used for consolidation provided that the gap between the reporting dates is three months or less.)
Consolidation adjustments	Review consolidation schedules, purchase, sales ledger and intra-group accounts to identify any intra-group transactions or outstanding balances, ensure these have been cancelled out in the group accounts. **Transactions involving group companies** Transactions involving group companies should be audited in the same way as other transactions with third parties. However, **systems should exist** to ensure all intra-group transactions are separately identified to ensure they are all appropriately eliminated on consolidation. **Intra-group balances** These should be audited in the same way as balances with third parties. In particular: • share certificates should be examined; • dividends should be verified; • intra-group balances should be verified including any security attaching thereto; • carrying amounts should be assessed in the same way as third-party investments; and • the need for transfer pricing adjustments assessed. **Intercompany guarantees** Any intercompany guarantees (eg, as surety for external loans) should be ascertained and consideration given to whether disclosure as a **contingent liability** is required.

12.6.4 Materiality

Where a subsidiary is immaterial, limited work will be performed. However, care should be taken with respect to the following:

- Apparently immaterial subsidiaries may be materially understated.
- Several small subsidiaries may cumulatively be material.
- Subsidiaries with a small asset base may engage in transactions of significant value and which may be relevant to understanding the group.

The following factors may influence component materiality levels:

- The fact that component materiality must always be lower than group materiality
- The size of the component
- Whether the component has a statutory audit
- The characteristics or circumstances that make the component significant
- The strength of the component's control environment
- The likely incidence of misstatements, taking account past experience

12.6.5 Understanding the group structure

There is a need to analyse the group structure. An understanding of the group structure allows the group auditor to:

- plan work to deal with different accounting frameworks or policies applied throughout the group;
- deal with differences in auditing standards; and
- integrate the group audit process effectively with local statutory audit requirements.

12.7 The consolidation: audit procedures

After receiving and reviewing all the subsidiaries' (and associates') financial statements, the **group** auditors will be in a position to audit the consolidated financial statements. The group auditors should not treat the consolidation as simply an arithmetical exercise. There are risks inherent in the consolidation process itself, for example:

- Consolidation adjustments are a major source of journal entries therefore procedures relating to the detection of fraud may be relevant.
- Risks may arise from incomplete information to support adjustments between accounting frameworks.

An important part of the work on the consolidation will be checking the consolidation adjustments. Consolidation adjustments generally fall into two categories:

- Permanent consolidation adjustments
- Consolidation adjustments for the current year

The audit steps involved in the consolidation process may be summarised as follows.

Step 1 Compare the audited accounts of each subsidiary/associate to the consolidation schedules to ensure figures have been transposed correctly.

Step 2 Review the adjustments made on consolidation to ensure they are appropriate and comparable with the previous year. This will involve the following:

- **Recording** the **dates** and **costs** of **acquisitions** of subsidiaries and the assets acquired
- **Calculating goodwill** and **pre-acquisition reserves** arising on consolidation
- **Preparing** an overall **reconciliation** of movements on reserves and NCIs
- **Adjusting** the individual subsidiary financial statements for **differences in accounting policies** compared to the parent. This may include compliance with the accounting regulations of a different jurisdiction (eg, where the individual subsidiary is UK GAAP compliant and the group reports under IFRS Standards)

Step 3 For business combinations, determine the following:

- Whether combination has been **appropriately** treated as an acquisition
- The **appropriateness** of the **date** used as the date of combination

- The **treatment** of the **results** of **investments** acquired during the year
- If acquisition accounting has been used, that the **fair value** of acquired **assets** and **liabilities** is in accordance with IFRS 13
- **Goodwill** has been **calculated correctly** and impairment adjustment made if necessary

Step 4 For disposals:

- agree the **date** used as the date for disposal to sales documentation; and
- review management accounts to ascertain whether the **results** of the **investment** have been **included** up to the date of disposal, and whether figures used are reasonable.

Step 5 **Consider** whether **previous treatment** of **existing subsidiaries** or **associates** is still **correct** (consider level of influence, degree of support).

Step 6 Verify the **arithmetical accuracy** of the consolidation workings by recalculating them.

Step 7 **Review** the **consolidated accounts** for **compliance** with the legislation, accounting standards and other relevant regulations. Care will need to be taken in the following circumstances:

- Where group companies do not have coterminous accounting periods
- Where subsidiaries are not consolidated
- Where accounting policies of group members differ because foreign subsidiaries operate under different rules, especially those located in developing countries
- Where elimination of intra-group balances, transactions and profits is required

Other important areas include the following:

- Treatment of associates
- Treatment of goodwill and intangible assets
- Foreign currency translation
- Taxation and deferred tax
- Treatment of loss-making subsidiaries
- Treatment of restrictions on distribution of profits of a subsidiary
- Share options

Step 8 **Review** the **consolidated accounts** to confirm that they give a true and fair view in the circumstances (including subsequent event reviews from all subsidiaries updated to date of audit report on consolidated accounts).

It is important for group auditors to considering the process used to perform the consolidation process. Where excel spreadsheets are used it is not enough to check the data that has been entered. Auditors also need to check that the consolidation spreadsheets are actually working properly.

Interactive question 12: Intra-group balances/profits

Your firm is the auditor of Beeston Industries, a limited company, which has a number of subsidiaries in your country (and no overseas subsidiaries), some of which are audited by other firms of professional accountants. You have been asked to consider the work which should be carried out to ensure that intra-group transactions and balances are correctly treated in the group accounts.

Requirements

12.1 Describe the audit procedures you would perform to check that intra-group balances agree, and state why intra-group balances should agree and the consequences of them not agreeing.

12.2 Describe the audit procedures you would perform to verify that intra-group profit in inventory has been correctly accounted for in the group accounts.

See **Answer** at the end of this chapter.

12.8 Overseas subsidiaries

The inclusion of one or more foreign subsidiaries within a group introduces additional risks, including the following:

- Non-compliance with the **accounting requirements** of IAS 21, *The Effects of Changes in Foreign Exchange Rates*
- Potential misstatement due to the effects of **high inflation**
- Possible difficulty in the parent being able to exercise **control**, for example due to political instability
- Currency restrictions limiting payment of profits to the parent
- There may be threats to **going concern** due to economic and/or political instability
- Non-compliance with local taxes or misstatement of local tax liabilities

Audit procedures should include the following:

- Confirm that the balances of the subsidiary have been appropriately translated to the group reporting currency:
- Assets and liabilities at the **closing rate** at the end of the reporting period
- Income and expenditure at the **rate ruling at the transaction date**. An average would be a suitable alternative provided there have been no significant fluctuations
- Confirm **consistency** of treatment of the translation of equity (closing rate or historical rate)
- Confirm that the **consolidation process** has been performed correctly eg, elimination of intra- group balances
- Recalculate the **non-controlling interest**
- Confirm that **goodwill** has been translated at the closing rate
- Confirm the **disclosure of exchange differences** as a separate component of equity
- Assess whether **disclosure requirements** of IAS 21 have been satisfied
- If the foreign operation is operating in a **hyperinflationary economy** confirm that the financial statements have been adjusted under IAS 29, *Financial Reporting in Hyperinflationary Economies* before they are translated and consolidated
- Involve a specialist tax audit team to review the calculation of tax balances against submitted and draft tax returns

12.9 Other considerations in the group context

Other considerations include the following.

12.9.1 Related parties

Remember that when auditing a consolidation, the relevant related parties are those related to the **consolidated group**. Transactions with consolidated subsidiaries need **not** be disclosed, as they are incorporated in the financial statements. However, related party relationships where there is control (eg, a parent) need to be disclosed even where there are no transactions with this party.

The group auditors are often requested to carry out the consolidation work even where the accounts of the subsidiaries have been prepared by the client. In these circumstances the auditors are, of course, acting as accountants and auditors and care must be taken to ensure that the **audit** function is carried out and evidenced.

Transfer pricing issues around transactions with related parties must also be considered. Transfer pricing adjustments, when they are required, are often material to the financial statements.

12.9.2 Support (comfort) letters

It is sometimes the case that a subsidiary, when considered in isolation, does not appear to be a going concern. In the context of group accounts, the parent and the subsidiary are seen to be a complete entity, so if the group as a whole is a going concern, that is sufficient.

When auditing the incorporation of the single company into the group accounts, however, the auditor will need assurance that the subsidiary is a going concern.

In such a case, the auditor may request a 'support letter' from the directors of the parent company. This letter states that the intention of the parent is to continue to support the subsidiary, which makes it a going concern. A support letter may be sufficient appropriate audit evidence on this issue, but further evidence would be bank guarantees.

12.10 Promoting best practice in group audits

The following practical guidance can be used for each stage of the group audit:

Understand group management's process and timetable to produce consolidated accounts	Understand the group structure and the nature of the components of the group Consider whether to accept an engagement where the group auditor is only directly responsible for a minority of the total group Understand the accounting framework applicable to each component and any local statutory reporting requirements Understand the component auditors – consider their qualifications, independence and competence For unrelated auditors or related auditors where the group auditor is unable to rely on common policies and procedures, consider the following: • Visiting the component auditor • Requesting that the component auditor completes a questionnaire or representation • Obtaining confirmation from a relevant regulatory body • Discussing the component auditor with colleagues from their own firm For component auditors based overseas consider whether they have enough knowledge and experience of ISAs

Design group audit process to match management's process and timetable	Get involved early. Talk to group management while they are planning the consolidation Draft instructions to component auditors allocating work and be clear as to deadlines required Focus the group audit on high risk areas Consider risks arising from the consolidation process itself: • Consolidation adjustments • Incomplete information to support adjustments between accounting frameworks eg, where a subsidiary prepares its local accounts under US GAAP and the parent is preparing IFRS financial statements Discuss fraud with component auditors and consider the following: • Business risks • How and where the group financial statements may be susceptible to material misstatement due to fraud or error
	• How group management and component management could perpetrate and conceal fraudulent financial reporting and how assets of the components could be misappropriated • Known factors affecting the group that may provide the incentive or pressure for group or component management or others to commit fraud or indicate a culture or environment that enables those people to rationalise committing fraud • The risk that group or component management may override controls Understand internal control across the group: • Request details of material weaknesses in internal controls identified by component auditors • Communicate material weaknesses in group-wide controls and significant weaknesses in internal controls of components to group management
Clearly communicate expectations and information required including timetable	Explain the extent of the group auditors' involvement in the work of the component auditors: • Make it clear what the component auditors are being asked to perform eg, a full audit, a review or work on specific balances or transactions • Clarify the timetable and format of reporting back Review completed questionnaires and other deliverables from component auditors carefully Decide whether and when to visit component auditors and when to request access to their working papers Get group management to obtain the consent of subsidiary management to communicate with the group auditor to deal with concerns about client confidentiality and sensitivity Consider whether holding discussions with or visiting component auditors could deal with secrecy and data-protection issues

Obtain information early where practicable	There is often only a short time for group auditors to resolve any issues arising from the report they receive from component auditors Request some information early, such as copies of management letter points from component auditors carrying out planning and control testing before the year end
Keep track of whether reports have been received and respond to any issues in a timely fashion	Where component auditors indicate up front that they will not be able to provide the information requested, consider alternatives rather than waiting until the sign-off deadline Put in place a system to monitor responses to instructions and follow up on non-submission
Conclude on the audit and consider possible improvements for the next year's process including management letter issues	The group auditors should be in a position to form their opinion on the group financial statements The group auditors will consider the need for a group management letter and reporting to those charged with governance of the group Debrief the team and consider whether the process worked as well as it could have done, along with any changes to future accounting and auditing requirements, and whether there are any issues that should be communicated to management and those charged with governance, or any changes to next year's audit strategy

13 Auditing global enterprises

Section overview

- Global enterprises are particularly affected by the following risks:
  - financial risks
  - political risks
  - regulatory risks
- Internal control will have to have regard to a variety of local requirements.
- Compliance will be a key feature of international business strategy.
- In response to the trend towards globalisation the Forum of Firms has been founded.

13.1 Introduction

Large businesses are increasingly becoming global organisations. This has implications for the business itself and the way in which the audit is conducted. In the remainder of this section we will look at a number of key issues affecting global organisations.

13.2 Inherent risk

13.2.1 Financial risk

By its very nature a global organisation will have businesses in countries all over the world. At any point in time these countries may be experiencing **diverse economic circumstances**. This may impact on key aspects of **financial management**, including the effects of the following:

- inflation
- interest rates
- exchange rates
- currency restrictions

In some instances the impact of these can be significant. For example, Venezuela experienced inflation in excess of 1,000,000% in 2019 (hyperinflation will be considered further in next Chapter).

Overseas financial risk

The **financial strategy** of the company may be one of **overseas financing**. This could be in two situations.

(a) The raising of finance overseas but remittance of funds back to the country – probably to take advantage of more reasonable terms

(b) The raising of finance overseas for the purpose of providing capital for an overseas subsidiary, branch or significant equity investment

Identifying overseas financial risks

The **business** choice between the above transactions can be summarised as follows.

- The legal requirements for raising loan capital in the country of origin may be more complex than the BDT equivalent.
- The tax implications may be diverse and difficult to manage.
- The country of origin may have strict rules on remittance of proceeds back to Bangaldesh.
- The company may have a cultural image or mission statement with which overseas financing conflicts.
- The decision to finance overseas may have been made on factors that can easily be distorted in the short term. The factors likely to have been considered would have been:
  - the prevailing rate of exchange
  - the cost of financing interest or dividend payments

Foreign exchange and interest rates are outside the control of the individual entity. Therefore, if there is an unfavourable movement in the foreign exchange or interest rates, it could result in a significant change in **cash flow** in both the short and long term.

Mitigating overseas financial risks

The business may choose to mitigate risk by adopting the following or similar procedures.

- The company should **obtain legal, taxation and accounting advice** before the overseas financing commencing.
- The company should **hedge** any overseas transactions to reduce the risk of currency and interest rate movements significantly affecting its assets and liabilities.
- The company at board level should consider the **cultural and political implications** of an investment overseas.

Assessing overseas financial risks

The assurance adviser can approach the assignment initially by focusing on business risk and, where necessary, with a more **substantive approach**.

The assurance adviser will therefore be addressing the issue of changing exchange and interest rates, where material, in the relevant accounting period. He would discuss with management any difficulties that had arisen over the legal requirements and whether remittance from overseas had proved straightforward.

The advisor would also have gained assurance that the company had identified the reporting requirements of the country.

Having addressed business risk, the following steps may need to be taken:

- Examination of the loan capital terms and contractual liabilities of the company
- Checking the remittance of proceeds between the country of origin and the company by reference to bank and cash records
- Reviewing the movement of exchange and interest rates, and discussing their possible impact with the directors
- Obtaining details of any hedging transaction and ensuring that exchange rate movements on the finance had been offset
- Examining the financial statements to determine accurate disclosure of accounting policy and accounting treatment conforming to locall requirements
- Evaluating whether the directors had satisfied themselves as to the company's conforming status as a going concern

13.2.2 Political risk

Political issues, particularly political unrest, may have implications for both the business and the way in which its results are reported. For example, restrictions imposed by foreign governments may call into question the ability of a parent to control its subsidiary. This may raise questions about **possible impairment** of the value of the parent's investment in the subsidiary and may affect the way in which the investment is recorded in the group financial statements.

13.2.3 Regulatory risk

A global organisation will need to be equipped to deal with a range of local legislation. Key areas include the following:

- health and safety
- environmental legislation
- trade descriptions
- consumer protection
- data protection
- employment issues

Failure to comply with these may result in **financial or other penalties**, having to spend money and resources in fighting litigation and loss of reputation.

In this area, **governance codes** will be particularly important examples of best practice which should be adopted worldwide, and organisations must consider the risks of breaching provisions relating to integrity and objectivity, and also control over the organisation as a whole.

Professional skills focus: Applying judgement

As we have often seen, the higher the risk of an audit assignment, the more important it is for the auditor to exercise judgement. For example, just because a firm has a code of governance does not mean that it will be complied with.

Audit impact

The variation in local regulation may have an impact on the audit itself. For example, some subsidiaries may be in countries which do not have accounting and auditing standards developed to the same extent as those in the country of Parent company. As a result, the financial statements and the audit work carried out on them by local practitioners of subsidiary companies **may not conform to the standards of the local requirements of parent company**.

In this situation, the group auditor may need to:

- request adjustments to be made to the financial statements of the subsidiary; and
- request additional audit procedures to be performed.

The increasing acceptance of international accounting and auditing standards and ongoing convergence between these and local regulation means that this problem should become less significant over time.

13.3 Internal control

Many of the internal control issues stem from the **inherent risks** identified above. For example, geographical, cultural and regulatory differences may result in a variety of internal control mechanisms being adopted by the organisation. The entity will need to ensure that these mechanisms satisfy not only local requirements but also the internal control objectives of the entity as a whole. The following specific points should be noted.

Risk management

The management of a global enterprise will need to have regard to the **corporate governance requirements** (see Chapter 4) as follows:

Control environment	This sets the tone from the top of the organisation and will need to be applicable at both a local and global level. Factors to consider include the following: • Organisational structure of the group • Level of involvement of the parent company in components • Degree of autonomy of management of components • Supervision of components' management by parent company • Information systems, and information received centrally on a regular basis
Risk assessment	The nature of a global organisation increases risk. Management need to ensure that a process is in place to identify the risks at the global level and assess their impact
Information systems	Information systems will need to be designed so that accurate and timely information is available both at the local level and on an entity basis. Compatibility of systems and processes will be important
Control procedures	While there may be local variations, minimum entity-wide standards must be established to ensure that there are adequate controls throughout the organisation
Monitoring	In organisations of this size audit committees and the internal audit function will have a crucial role to play

13.3.1 Transfer pricing

Transfer pricing addresses the need to value the use of goods and services of one division by another. A well thought-out system may allow accurate **divisional performance measurement** while ensuring that divisions are not motivated to make decisions adverse for the company as a whole.

Transfer pricing systems have four primary aims:

(a) To enable the **realistic measurement of divisional profit**

(b) To provide producer and receiver with **realistic income and cost**

(c) To avoid taking **too much autonomy** from managers

(d) To ensure **goal congruence and profit maximisation** for the company as a whole

Transfer pricing is notoriously difficult to get right. One particular problem associated with transfer prices is in valuing a company or division as an independent unit. For example, a division of a major company is likely to find major costs (eg, rent) to be much higher without the economic support of a parent.

Where the product or service has a readily available outside market, internal transfers are unlikely to occur unless the transfer price is similar to the market price. The transfer price may be slightly below the market price to recognise the reduction in risk (eg, no cash changes hands so risk of bad debts may be reduced) and likely savings in packing and delivery.

Another method used to set transfer prices is **'cost plus'**. The transferring division should be able to recover its variable costs and any contribution lost because it diverted resources in order to fulfil the internal transfer. The costs involved should be standard rather than actual, otherwise inefficiencies in the selling division will be passed on to the buying division.

The choice of the most appropriate transfer pricing method depends on the nature of the business and the level of risks borne by the selling division.

Transfer pricing can be used to **manipulate profits for tax purposes, rather than to measure performance.** Consequently, transfer pricing issues have come to the top of the agenda for tax authorities worldwide, and become the focus of an increasing number of NBR and Customs duty inquiries (particularly where they involve transactions between divisions which are resident in different countries).

Context example: Divisional performance

Company C is organised into two divisions, Division A and Division B. Division A can sell its product outside the company at £20 per unit or transfer internally to Division B at £20 per unit.

Division B buys the product from Division A and develops it into a higher-margin finished product. The division's usual selling price for its finished product is £70.

Division A's variable costs are £10 per unit and its fixed costs are £5 per unit. Division B's variable costs are £15 per unit and its fixed costs are £10 per unit.

If Division B received an offer from a customer of £30 per unit for its final product, it would not accept the offer. This is because, taking the transfer price of £20 into account, its accounts would show a negative contribution per unit of (30 – 20 – 15) £5.

However, assuming that Division A has surplus capacity, Company C would accept the offer. From the point of view of the company as a whole, the contribution would be positive: (30 – 10 – 15) £5 per unit.

If Division A is already operating at full capacity then there would be a lost external sales contribution in A of (20 – 10) £10. Therefore, in this situation, the company as a whole should also reject the offer because the deal would represent a loss in potential contribution of £5 per unit.

If challenged by the tax authorities, transfer pricing adjustments can have a material impact on the selling and buying divisions' corporation tax expense and tax liabilities. It may also change the recognition of intercompany revenue in the individual companies' financial statements.

Auditing the transfer pricing status of large multinational groups often requires the involvement of tax specialists. Issues that the auditor should consider when reviewing the company's transfer pricing policies include the following:

(a) Are there any unresolved tax enquiries/tax audits relating to transfer pricing?

(b) Has an Advance Transfer Pricing Agreement been signed between the group and the tax authorities? If so, does the transfer pricing policy applied in the period conform to the Agreement?

(c) Is the transfer pricing method adopted appropriate for the type of transaction, and the nature of the selling division's business?

(d) Do the transfer prices appear reasonable, compared to existing benchmarks (for example, is the percentage of mark-up in a cost-plus policy in line with the mark-ups applied by comparable companies in the industry)?

(e) Have there been any changes in the divisions' business, which may require the transfer pricing policy to be revised?

13.4 Compliance

A key feature of any international business strategy is that it is likely to involve compliance with overseas accounting and auditing regulations of the host countries in which an entity does business. The most important piece of recent legislation in this respect has been the **Sarbanes-Oxley Act which** is covered in detail in earlier Chapter of this Workbook.

13.5 Transnational audits

13.5.1 The Forum of Firms

In response to the trend towards globalisation an international grouping, the Forum of Firms (FoF), was founded by the following networks: BDO, Deloitte Touche Tohmatsu, Ernst & Young, Grant Thornton, KPMG and PricewaterhouseCoopers.

Membership is open to firms and networks that have transnational audit appointments or are interested in accepting such appointments.

These firms have a voluntary agreement to meet certain requirements that are set out in their constitution. These relate mainly to the following:

- Promoting the use of high-quality audit practices worldwide, including the use of ISAs
- Maintaining quality management standards in accordance with International Standards on Quality Management issued by the IAASB, and conducting globally co-ordinated internal quality assurance reviews

The **Transnational Auditors Committee** (TAC) provides guidance to the members of the FoF and provides the official linkage between the FoF and the International Federation of Accountants (IFAC).

The TAC has issued the following definition of transnational audit.

Definition

Transnational audit: An audit of financial statements which are or may be relied upon outside the audited entity's home jurisdiction for purposes of significant lending, investment or regulatory decisions; this will include audits of all financial statements of companies with listed equity or debt and other public interest entities which attract particular public attention because of their size, products or services provided.

Audits of entities with listed equity or debt are always transnational audits, as their financial statements are or may be relied upon outside their home jurisdiction. Other audits that are transnational audits include audits of those entities in either the public or the private sectors where there is a reasonable expectation that the financial statements of the entity may be relied upon by a user outside the entity's home jurisdiction for purposes of significant lending, investment or regulatory decisions, whether or not the entity has listed equity or debt or where entities attract particular attention because of their size, products or services provided. (These would include, for example, large charitable organisations or trusts, major monopolies or duopolies, providers of financial or other borrowing facilities to commercial or private customers, deposit-taking organisations and those holding funds belonging to third parties in connection with investment or savings activities.)

In principle, the definition of transnational audit should be applied to the whole group audit, including the individual components comprising the consolidated entity.

Examples to illustrate the definition:

Example	Explanation
Audit of a private company in the US raising debt finance in Canada	This would qualify as a transnational audit, as it is reasonable to expect that the financial statements of the company would be used across national borders in obtaining the debt financing.
Audit of a private savings and loans business operating entirely in the US (ie, only US depositors and US investments)	Although it could be considered a public interest entity, this would not qualify as a transnational audit assuming it can be demonstrated that there are no transnational users. In applying the definition of transnational audit, there should be a rebuttable presumption that all banks and financial institutions are included, unless it can be clearly demonstrated that there is no transnational element from the perspective of a financial statement user and that there are no operations across national borders. Potential transnational users would include investors, lenders, governments, customers and regulators.
Audit of an international charity taking donations through various national branches and making grants around the world	This entity can clearly be considered a public interest entity and operating across borders. Further, the international structure would create a reasonable expectation that the financial statements could be used across national borders by donors in other countries if not by others for purposes of significant lending, investment or regulatory decisions. The audit is likely to qualify as transnational.

13.5.2 Features of transnational audits

In the globalised business and financial environment, many audits are clearly transnational, and this produces a number of specific problems which can limit the reliability of the audited financial statements:

- Regulation and oversight of auditors differs from country to country
- Differences in auditing standards from country to country
- Variability in audit quality in different countries

13.5.3 Role of the international audit firm networks

The 'Big 4' and other international networks of firms can be seen as being ahead of governments and institutions in terms of their global influence. They are in a position to establish consistent practices worldwide in areas such as:

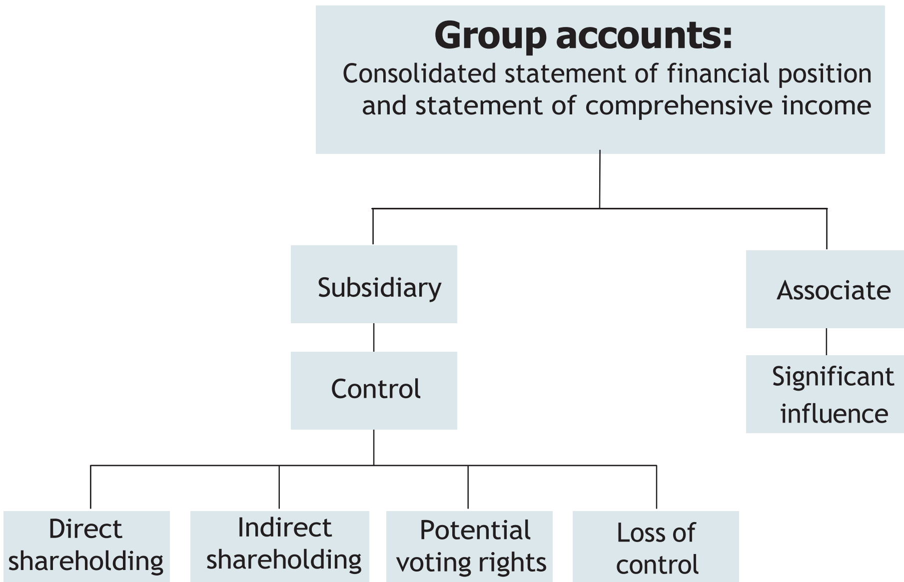
- training and education
- audit procedures
- quality control procedures

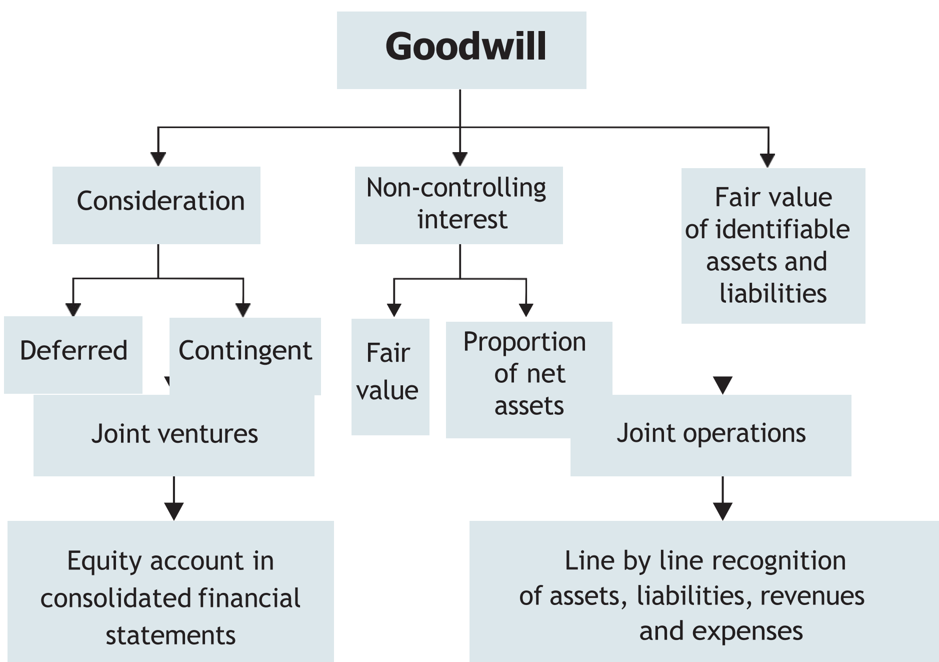
These firms may as a result be in a better position than national regulators to ensure consistent implementation of high-quality auditing standards.

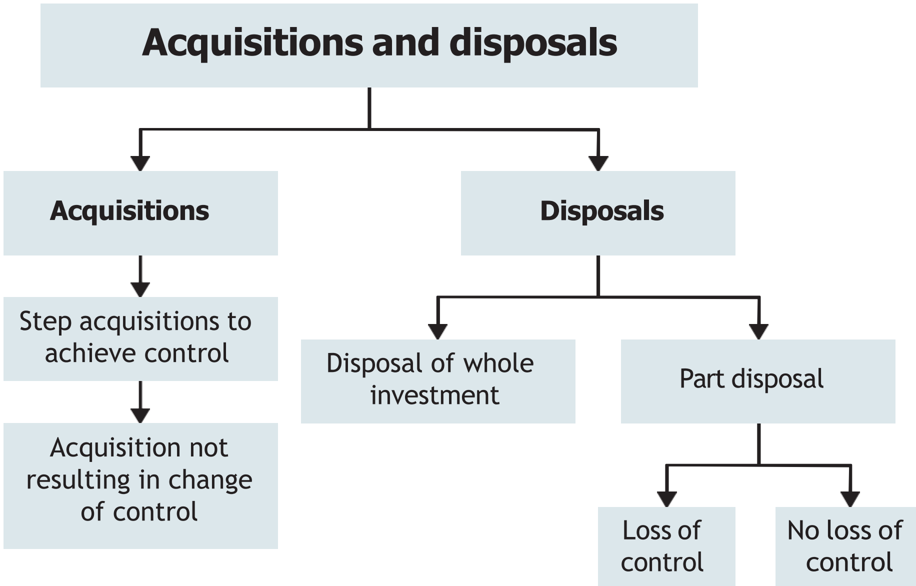
Membership of the Forum of Firms imposes commitments and responsibilities, namely to:

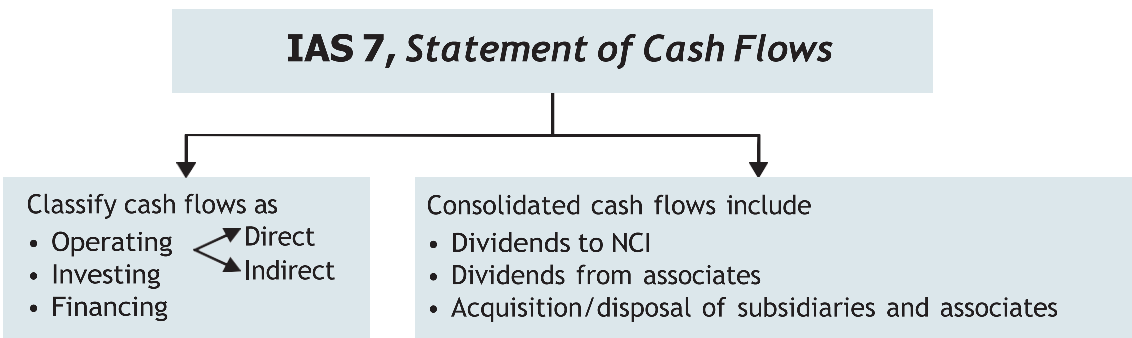
- perform transnational audits in accordance with ISAs;
- comply with the IESBA Code of Ethics; and
- be subject to a programme of quality assurance.

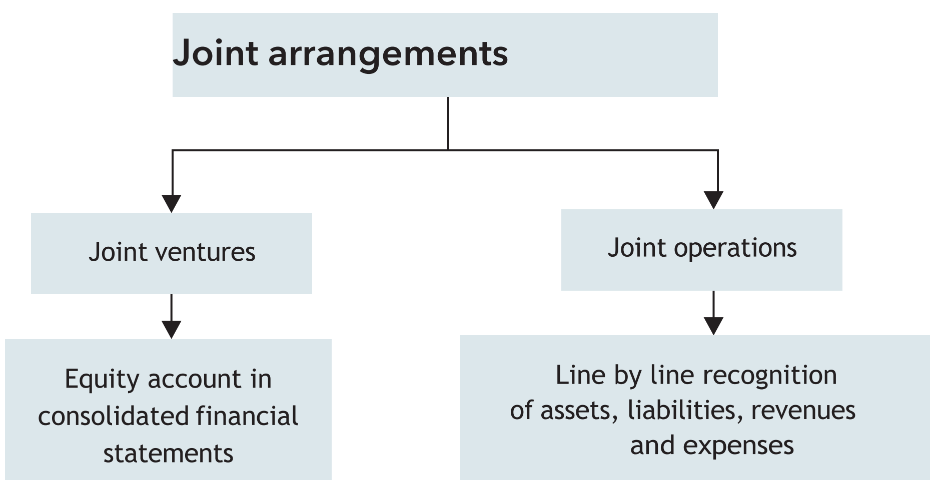
Summary


Group accounts:
Consolidated statement of financial position and statement of comprehensive income
Subsidiary
Associate
Control
Significant influence
Direct shareholding
Indirect shareholding
Potential voting rights
Loss of control


Goodwill
Consideration
Non-controlling interest
Fair value of identifiable assets and liabilities
Deferred
Contingent
Fair value
Proportion of net assets
Joint ventures
Joint operations
Equity account in consolidated financial statements
Line by line recognition of assets, liabilities, revenues and expenses


Acquisitions and disposals
Acquisitions
Disposals
Step acquisitions to achieve control
Acquisition not resulting in change of control
Disposal of whole investment
Part disposal
Loss of control
No loss of control


IAS 7, *Statement of Cash Flows*
Classify cash flows as
• Operating
• Investing
• Financing
Direct
Indirect
Consolidated cash flows include
• Dividends to NCI
• Dividends from associates
• Acquisition/disposal of subsidiaries and associates


Joint arrangements
Joint ventures
Joint operations
Equity account in consolidated financial statements
Line by line recognition of assets, liabilities, revenues and expenses

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Can you apply the IFRS 10 definition of control? (Topic 2)
2.	How should goodwill be calculated? How should it be treated subsequent to the acquisition? (Topic 3)
3.	How should contingent consideration be measured subsequent to the acquisition? (Topic 3)
4.	Can you apply IFRS 3, *Fair Value Measurement* to business combinations? (Topic 4)
5.	Where an entity prepares separate financial statements how should it account for associates and joint ventures in its separate financial statements? (Topic 5)
6.	Can you account for disposals (Topic 10) and business combinations achieved in stages (Topic 9)?
7.	Do you understand the potential risks faced by the auditor when auditing group financial statements? (Topic 13)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Burdett	This is a straightforward calculation of goodwill, but also requires you to know the treatment of a gain on a bargain purchase.
Gibston	A further calculation of goodwill, this tests deferred and contingent consideration and the net asset calculation is more complicated than for Burdett.
Green and Yellow	An explanation of joint arrangements under IFRS 11 is required.
Fleurie	This question contains a disposal where control is retained.
Chianti	In contrast, in this disposal, control is lost.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios to help you improve knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Upstart Records requirement (1)	This requires a detailed explanation with calculations of the treatment of goodwill and non-controlling interest on consolidation.
Poe, Whitman & Co (disposal of Scherzo only)	This focuses on audit and ethical issues relating to the partial disposal of a subsidiary.
EyeOp requirement (1)	This is a calculation of goodwill with a business combination achieved in stages (financial asset to subsidiary).

Refer back to the learning in this chapter for any questions which you did not answer correctly, or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving onto the next chapter.

Technical reference

1 IFRS 3, Business Combinations

Basics

- Definitions: control, parent, subsidiary, acquisition date, goodwill – **IFRS 3 (App A)**
- Acquisition method: acquirer, acquisition date, recognising and measuring assets, liabilities, non- controlling interest and goodwill – **IFRS 3.5**

Measurement of identifiable assets acquired

- At fair value – **IFRS 3.18**
- Non-controlling interest measured at fair value or as a proportionate share of the acquiree's net assets – **IFRS 3.19**
- Exceptions to measurement principles
  - Contingent liabilities recognised if fair value measured reliably regardless of probable outcome – **IFRS 3.23**
  - Income taxes in accordance with IAS 12 – **IFRS 3.24**
  - Employee benefits in accordance with IAS 19 – **IFRS 3.26**
  - Assets held for sale in accordance with IFRS 5 – **IFRS 3.31**

Consideration transferred

- Fair value of assets transferred, liabilities incurred and equity instruments issued – **IFRS 3.37**
- Contingent consideration accounted for at fair value – **IFRS 3.39**
- Subsequent accounting for contingent consideration – **IFRS 3.58**
- Acquisition related costs – **IFRS 3.53**

Goodwill

- Calculation – **IFRS 3.32**

Bargain purchases

- Reassess identification and measurement of the net assets acquired, the non-controlling interest, if any, and consideration transferred – **IFRS 3.36**
- Any remaining amount recognised in profit or loss in period the acquisition is made – **IFRS 3.34**

Business combination achieved in stages (step acquisition)

- Remeasure previously held interest to fair value at acquisition date – **IFRS 3.42**

Measurement period

- Adjustment to amounts only within 12 months of acquisition date – **IFRS 3.45**
- Subsequently: errors accounted for retrospectively, everything else prospectively – **IFRS 3.50**

Disclosures

- Business combinations occurring in the accounting period or after its finish but before financial statements authorised for issue (in the latter case, by way of note) – **IFRS 3.59**

2 IFRS 10, Consolidated Financial Statements

Basic rule

- Parent must prepare CFS to include all subsidiaries – **IFRS 10.2**

Exception

- No need for CFS if wholly owned or all non-controlling shareholders have been informed of and none have objected to the plan that CFS need not be prepared – **IFRS 10.4**

Control – IFRS 10.7

- Power over the investee
- Exposure or rights to variable returns
- Ability to use its power
- Power is existing rights that give the current ability to direct the relevant activities of the investee

Procedures

- Non-controlling interest shown as a separate figure:
- In the statement of financial position, within total equity but separately from the parent shareholders' equity – **IFRS 10.22**
- In the statement of profit or loss and other comprehensive income, the share of the profit after tax and share of the total comprehensive income
- Accounting dates of group companies to be no more than three months apart – **IFRS 10.B93**
- Uniform accounting policies across group or adjustments to underlying values – **IFRS 10.19**
- Bring in share of new subsidiary's income and expenses: – **IFRS 10.20**
- From date of acquisition, on acquisition
- To date of disposal, on disposal
- Changes that do not result in a loss of control accounted for as equity transactions – **IFRS 10.B96**

Loss of control – IFRS 10.B97–99

- Calculation of gain
- Account for amounts in other comprehensive income as if underlying assets disposed of
- Retained interest accounted for in accordance with relevant standard based on fair value

Parent's separate financial statements

- Account for subsidiary on basis of cost and distributions declared – **IAS 27.12**

3 IAS 28, Investments in Associates and Joint Ventures

Definitions

- The investor has significant influence, but not control – **IAS 28.2**
- Significant influence is the power to participate in financial and operating policy decisions of the investee, but is not control over those policies (if the investor had control, then under IFRS 10 the investee would be its subsidiary) – **IAS 28.3**
- Presumptions re less than 20% and 20% or more – **IAS 28.5**
- Can be an associate, even if the subsidiary of another investor

Equity method

- In statement of financial position: non-current asset = cost plus share of post-acquisition change in A's net assets – **IAS 28.10**
- In statement of profit or loss: share of A's post-tax profits less any impairment loss – **IAS 28.32**
- In statement of changes in equity: share of A's changes – **IAS 28.10**
- Use IAS 27 to account in investor's separate financial statements – **IAS 28.44**
- Also applies to joint ventures – **IAS 28.10**

Disclosures

These are specified in IFRS 12, *Disclosure of Interests in Other Entities*.

4 Key areas of consolidations

- Control still possible if less than 50% of the voting rights owned – **IAS 27.13**
- Potential voting rights – **IAS 27.14–15**
- Loss of control – **IAS 27.32-34**
- Contingent consideration – **IFRS 3.39–40,58**

5 IFRS 11, Joint Arrangements

- Definitions – **Appendix A**
- Two forms of joint arrangement – **IFRS 11.6**
- Contractual arrangement – **IFRS 11.5**
- Joint ventures – **IFRS 11.24**
  - Equity method
- Joint operations – **IFRS 11.20**
  - What a joint operation is
  - Line by line recognition

6 Consolidated statements of cash flows

- Only cash flows between the group and an associate are reported in the group statement of cash flows with respect to associates – **IAS 7.37**
- Aggregate cash flows from acquisitions and disposals of subsidiaries presented as investing activities – **IAS 7.39**

7 Audit of groups

- Definitions:
  - Group audit partner and group engagement team – **ISA 600.9**
  - Component auditor – **ISA 600.9**
- Responsibility – **ISA 600.11**
- Acceptance considerations – **ISA 600.12–.13**
- Procedures to assess the extent to which the component auditor can be relied upon – **ISA 600.19–.20**
- Significant components – **ISA 600.26–.27**
- Communication with component auditors – **ISA 600.40–.41**
- Communication with group management and those charged with governance – **ISA 600.46–.49**

Self-test questions

Answer the following questions

1 **Burdett**

The Burdett Company acquired an 80% interest in The Swain Company for £1,340,000 when the fair value of Swain's identifiable assets and liabilities was £1,200,000.

Burdett acquired a 60% interest in The Thamin Company for £340,000 when the fair value of Thamin's identifiable assets and liabilities was £680,000.

Neither Swain nor Thamin had any contingent liabilities at the acquisition date and the above fair values were the same as the carrying amounts in their financial statements. Annual impairment reviews have not resulted in any impairment losses being recognised. The Burdett Company values the non-controlling interest as the proportionate interest in the identifiable net assets at acquisition.

Requirement

Under IFRS 3, *Business Combinations*, what figures in respect of goodwill and of the excess of assets and liabilities acquired over the cost of combination should be included in Burdett's consolidated statement of financial position?

2 **Sheliak**

The Sheliak Company acquired equipment on 1 January 20X3 at a cost of £1,000,000, depreciating it over eight years with a nil residual value.

On 1 January 20X6 The Parotia Company acquired 100% of Sheliak and estimated the fair value of the equipment at £575,000, with a remaining life of five years. This fair value was not incorporated into Sheliak's books and subsequent depreciation charges continued to be made by reference to original cost.

Requirement

Under IFRS 3, *Business Combinations* and IFRS 10, *Consolidated Financial Statements*, what adjustments should be made to the depreciation charge for the year and the SFP carrying amount in preparing the consolidated financial statements for the year ended 31 December 20X7?

3 **Finch**

On 1 January 20X6 The Finch Company acquired 85% of the ordinary share capital and 40% of the irredeemable preference share capital of The Sequoia Company for consideration totalling £5.1 million. At the acquisition date Sequoia had the following statement of financial position.

	£'000
Non-current assets	5,500
Current assets	2,600
	8,100

Ordinary shares of £1	1,000
Preference shares of £1	2,500
Retained earnings	3,300
Current liabilities	1,300
	8,100

Included in non-current assets of Sequoia at the acquisition date was a property with a carrying amount of £600,000 that had a fair value of £900,000.

Sequoia had been making losses, so Finch created a provision for restructuring of £800,000 under plans announced on 2 January 20X6.

Sequoia has disclosed in its accounts a contingent liability with a reliably estimated value of £20,000. Sequoia has not recorded this as a provision, as payment is not considered probable.

Finch values the non-controlling interest using the proportion of net assets method.

Requirement

Under IFRS 3, *Business Combinations*, what goodwill arises at the time of the acquisition of Sequoia?

4 Maackia

On 31 December 20X7 The Maackia Company acquires 65% of the ordinary share capital of The Sorbus Company for £4.8 million. Sorbus is incorporated in Flatland, which has not adopted IFRS for its financial statements. At the acquisition date the fair value of a 35% interest in Sorbus is £1.8 million and net assets of Sorbus have a carrying amount of £4.6 million before taking into account the following.

Included in the net assets of Sorbus is a business that Maackia has put on the market for immediate sale. This business has a carrying amount of £500,000, a fair value of £760,000 and a value in use of £810,000. Costs to sell are estimated at £40,000.

Sorbus also has a defined benefit pension plan which has a plan asset of £1.6 million, and an obligation with present value of £1,280,000. Sorbus has recognised the net plan asset of £320,000 in its statement of financial position. Maackia does not anticipate any reduction in contributions as a result of acquiring Sorbus.

Requirement

Under IFRS 3, *Business Combinations*, what (to the nearest £1,000) is the goodwill arising on the acquisition of Sorbus, assuming that Maackia measures the non-controlling interest using the fair value method?

5 Gibbston

On 1 May 20X7 The Gibbston Company acquired 70% of the ordinary share capital of The Crum Company for consideration of £15 million cash payable immediately and £5.5 million payable on 1 May 20X8. Further consideration of £13.3 million cash is payable on 1 May 20Y0 dependent on a range of contingent future events. The management of Gibbston believe there is a 45% probability of paying the amount in full.

The equity of Crum had a carrying amount of £20 million at 1 January 20X7. Crum incurred losses of £3 million evenly over the year ended 31 December 20X7. The carrying amount and fair values of the assets of Crum are the same except that at the acquisition date the fair value relating to plant is £9 million higher than carrying amount. The weighted average remaining useful life of the plant is three years from the acquisition date.

Requirements

Calculate the following amounts (to the nearest £0.1m) in accordance with IFRS 3, *Business Combinations* and IFRS 10, *Consolidated Financial Statements* that would be included in the consolidated financial statements of Gibbston for the year ended 31 December 20X7.

(a) Goodwill

(b) Non-controlling interest in profit/loss

(c) Non-controlling interest included in equity

Note: A rate of 10% is to be used in any discount calculations. The non-controlling interest is measured using the proportion of net assets method.

6 Supermall

This question is based on Illustrative example 2 from IFRS 11.

Two real estate companies (the parties) set up a separate vehicle (Supermall) for the purpose of acquiring and operating a shopping centre. The contractual arrangement between the parties establishes joint control of the activities that are conducted in Supermall. The main feature of Supermall's legal form is that the entity, not the parties, has rights to the assets, and obligations for the liabilities, relating to the arrangement. These activities include the rental of the retail units, managing the car park, maintaining the centre and its equipment, such as lifts, and building the reputation and customer base for the centre as a whole.

The terms of the contractual arrangement are such that:

(1) Supermall owns the shopping centre. The contractual arrangement does not specify that the parties have rights to the shopping centre.

(2) The parties are not liable in respect of the debts, liabilities or obligations of Supermall. If Supermall is unable to pay any of its debts or other liabilities or to discharge its obligations to third parties, the liability of each party to any third party will be limited to the unpaid amount of that party's capital contribution.

(3) The parties have the right to sell or pledge their interests in Supermall.

(4) Each party receives a share of the income from operating the shopping centre (which is the rental income net of the operating costs) in accordance with its interest in Supermall.

Requirement

Explain how Supermall should be classified in accordance with IFRS 11, *Joint Arrangements*.

7 Green and Yellow

Green entered into an agreement with Yellow, a public limited company, on 1 December 20X8. Each of the companies holds one-half of the equity in an entity, Orange, a public limited company, which operates offshore oil rigs. The contractual arrangement between Green and Yellow establishes joint control of the activities that are conducted in Orange. The main feature of Orange's legal form is that Orange, not Green or Yellow, has rights to the assets, and obligations for the liabilities, relating to the arrangement.

The terms of the contractual arrangement are such that:

(1) Orange owns the oil rigs. The contractual arrangement does not specify that Green and Yellow have rights to the oil rigs.

(2) Green and Yellow are not liable in respect of the debts, liabilities or obligations of Orange. If Orange is unable to pay any of its debts or other liabilities or to discharge its obligations to third parties, the liability of each party to any third party will be limited to the unpaid amount of that party's capital contribution.

(3) Green and Yellow have the right to sell or pledge their interests in Orange.

(4) Each party receives a share of the income from operating the oil rig in accordance with its interest in Orange.

Green wants to account for the interest in Orange by using the equity method, and wishes for advice on the matter.

Green also owns a 10% interest in a pipeline, which is used to transport the oil from the offshore oil rig to a refinery on the land. Green has joint control over the pipeline and has to pay its share of the maintenance costs. Green has the right to use 10% of the capacity of the pipeline. Green wishes to show the pipeline as an investment in its financial statements to 30 November 20X9.

Requirement

Discuss how the above arrangements would be accounted for in Green's financial statements.

8 Stuhr

On 1 January 20X6 The Stuhr Company acquired 30% of the ordinary share capital of the Bismuth Company by the issue of one million shares with a fair value of £4.00 each. From that date Stuhr did not exercise significant influence over Bismuth, and accounted for the investment at fair value with changes in value included in profit or loss. At 1 January 20X6 the net assets of Bismuth had a carrying amount of £6.4 million and a fair value of £7.2 million.

On 1 March 20X7, Stuhr bought a further 50% of the ordinary share capital of Bismuth by issuing a further 2 million shares with a fair value of £5.00 each. At that date the net assets of Bismuth had a carrying amount of £7.8 million and a fair value of £8.4 million. The non-controlling interest had a fair value of £2 million, and the 30% interest already held by Stuhr had a fair value of £3 million.

Stuhr values the non-controlling interest using the full goodwill method.

Requirement

What is the goodwill figure in the consolidated statement of financial position at 31 December 20X7, in accordance with IFRS 3, *Business Combinations*?

9 Fleurie

Fleurie bought 85% of Merlot on 30 June 20X3, providing consideration in the form of £2 million cash immediately and a further £1.5 million cash conditional upon earnings targets being met.

At acquisition, the net assets of Merlot were £2.2 million and the fair value of the 15% not purchased was £350,000. Fleurie measures the non-controlling interest using the full goodwill method.

On 31 December 20X7, as part of a long-term strategy, Fleurie sold a 15% stake from its 85% holding in Merlot, realising proceeds of £560,000. At this date the net assets of Merlot were £3.5 million.

Requirement

What impact does the disposal have on the financial statements of the Fleurie Group?

10 Chianti

Chianti purchased 95% of the 100,000 £1 ordinary share capital of Barolo on 1 January 20X2, giving rise to goodwill of £70,000. At this date Barolo's retained earnings were £130,000.

There were no other reserves.

On 30 September 20X2, when the net assets of Barolo were £320,000, Chianti disposed of the majority of its holding in Barolo, retaining just 5% of share capital, with a fair value of £20,000. Chianti received £340,000 consideration for the sale.

The following information is relevant:

- Goodwill in Barolo has been impaired by £20,000.
- In April 20X2, Barolo revalued a plot of land from £50,000 to £75,000. This land was held with the intention of building a new head office on it.
- The non-controlling interest is valued using the proportion of net assets method.

Requirement

What is the impact of the disposal on the Chianti Group statement of profit or loss and other comprehensive income?

11 Porter

The following consolidated financial statements relate to Porter, a public limited company:

Porter group: statement of financial position as at 31 May 20X6

	20X6 £m	20X5 £m
Non-current assets		
Property, plant and equipment	958	812
Goodwill	15	10
Investment in associate	48	39
	1,021	861
Current assets		
Inventories	154	168
Trade receivables	132	112
Financial assets at fair value through profit or loss	16	0
Cash and cash equivalents	158	48
	460	328
	1,481	1,189
Equity attributable to owners of the parent		
Share capital (£1 ordinary shares)	332	300
Share premium account	212	172
Retained earnings	188	165
Revaluation surplus	101	54
	833	691

Non-controlling interests	84	28
	917	719
Non-current liabilities		
Long-term borrowings	380	320
Deferred tax liability	38	26
	418	346
Current liabilities		
Trade and other payables	110	98
Interest payable	8	4
Current tax payable	28	22
	146	124
	1,481	1,189

Porter group: statement of profit or loss and other comprehensive income for the year ended 31 May 20X6

	£m
Revenue	956
Cost of sales	(634)
Gross profit	322
Other income	6
Distribution costs	(97)
Administrative expenses	(115)
Finance costs	(16)
Share of profit of associate	12
Profit before tax	112
Income tax expense	(34)
	£m
Profit for the year	78
Other comprehensive income (items that will not be reclassified to profit or loss):	
Gains on property revaluation	58
Share of other comprehensive income of associate	8
Income tax relating to items of other comprehensive income	(17)
Other comprehensive income for the year, net of tax	49
Total comprehensive income for the year	127

	£m
Profit attributable to:	
Owners of the parent	68
Non-controlling interests	10
	78
Total comprehensive income attributable to:	
Owners of the parent	115
Non-controlling interests	12
	127

The following information relates to the consolidated financial statements of Porter:

(1) During the period, Porter acquired 60% of a subsidiary. The purchase was effected by issuing shares of Porter on a 1 for 2 basis, at their market value on that date of £2.25 per share, plus £26 million in cash.

A statement of financial position of the subsidiary, prepared at the acquisition date for consolidation purposes, showed the following position:

	£m
Property, plant and equipment	92
Inventories	20
Trade receivables	16
Cash and cash equivalents	8
	136
Share capital (£1 shares)	80
Reserves	40
	120
Trade payables	12
Income taxes payable	4
	136

An impairment test conducted at the year end resulted in a write down of goodwill relating to another wholly owned subsidiary. This was charged to cost of sales.

Group policy is to value non-controlling interests at the date of acquisition at the proportionate share of the fair value of the acquiree's identifiable assets acquired and liabilities assumed.

(2) Depreciation charged to the consolidated profit or loss amounted to £44 million. There were no disposals of property, plant and equipment during the year.

(3) Other income represents gains on financial assets at fair value through profit or loss. The financial assets are investments in quoted shares. They were purchased shortly before the year end with surplus cash, and were designated at fair value through profit or loss as they are expected to be sold shortly after the year end. No dividends have yet been received.

(4) Included in 'trade and other payables' is the £ equivalent of an invoice for 102 million

shillings for some equipment purchased from a foreign supplier. The asset was invoiced on 5 March 20X6, but had not been paid for at the year end, 31 May 20X6.

Exchange gains or losses on the transaction have been included in administrative expenses. Relevant exchange rates were as follows:

Shillings to £1

5 March 20X6 = 6.8

31 May 20X6 = 6.0

(5) Movement on retained earnings was as follows:

	£m
At 31 May 20X5	165
Total comprehensive income	68
Dividends paid	(45)
At 31 May 20X6	188

Requirement

Prepare a consolidated statement of cash flows for Porter for the year ended 31 May 20X6 in accordance with IAS 7, *Statement of Cash Flows*, using the indirect method.

Notes to the statement of cash flows are not required.

12 Tastydesserts

The following are extracts from the financial statements of Tastydesserts and one of its wholly owned subsidiaries, Custardpowders, the shares in which were acquired on 31 October 20X2.

Statements of financial position

Tastydesserts and subsidiaries Custardpowders

	31 December 20X2 £'000	31 December 20X1 £'000	31 October 20X2 £'000
Non-current assets			
Property, plant and equipment	4,764	3,685	694
Goodwill	42	–	–
Investment in associates	2,195	2,175	
	7,001	5,860	694
Current assets			
Inventories	1,735	1,388	306
Receivables	2,658	2,436	185
Bank balances and cash	43	77	7
	4,436	3,901	498

Tastydesserts and subsidiaries Custardpowders	31 December 20X2 £'000	31 December 20X1 £'000	31 October 20X2 £'000
	11,437	9,761	1,192
Equity			
Share capital	4,896	4,776	400
Share premium	216	–	–
Retained earnings	2,540	2,063	644
	7,652	6,839	1,044
Non-current liabilities			
Loans	1,348	653	–
Deferred tax	111	180	
	1,459	833	
Current liabilities			
Payables	1,915	1,546	148
Bank overdrafts	176	343	–
Current tax payable	235	200	
	2,326	2,089	148
	11,437	9,761	1,192

Consolidated statement of profit or loss and other comprehensive income for the year ended 31 December 20X2

	£'000
Profit before interest and tax Finance costs	546
Share of profit of associates	– 120
Profit before tax	666
Income tax expense	126
Profit/total comprehensive income for the year	540
Attributable to:	
Owners of the parent	540
Non-controlling interests	540

The following information is also given:

(1) The consolidated figures at 31 December 20X2 include Custardpowders.

(2) The amount of depreciation on property, plant and equipment during the year was £78,000. There were no disposals.

(3) The cost on 31 October 20X2 of the shares in Custardpowders was £1,086,000 comprising the issue of £695,000 unsecured loan stock at par, 120,000 ordinary shares of £1 at a value of 280p each and £55,000 in cash.

(4) No write-down of goodwill was required during the period.

(5) Total dividends paid by Tastydesserts (parent) during the period amounted to £63,000.

Requirement

Prepare a consolidated statement of cash flows for Tastydesserts and subsidiaries for the year ended 31 December 20X2 using the indirect method.

Notes to the statement of cash flows are not required.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

Goodwill on acquisition of DEF

		£'000
Consideration	3m shares issued at £7	21,000
	1m additional shares at £7	7,000
Non-controlling interest	10% × £18m	1,800
		29,800
Net assets acquired		(18,000)
Goodwill		11,800

Answer to Interactive question 2

£99,750

Net assets of Ives

	At acquisition	**At reporting date**
	£	**£**
Share capital	100,000	100,000
Retained earnings	150,000	245,000
FV adjustment	50,000	–
PURP in inventory		(6,000)
	300,000	339,000

Non-controlling interest

	£	**£**
Share of net assets (25% × 339,000)		84,750
Share of goodwill:		
NCI at acquisition date at fair value		90,000
NCI share of net assets at acquisition date (25% × £300,000)		(75,000)
		15,000
		99,750

Answer to Interactive question 3

Goodwill on consolidation of Kono Ltd

	£m	£m
Consideration (£2.00 × 6m)		12.0
	£m	£m
Non-controlling interest Share capital	8.0	
Pre-acquisition retained earnings	4.4	
Fair value adjustments		
Property, plant and equipment (16.8 – 16.0)	0.8	
Inventories (4.2 – 4.0)	0.2	
Contingent liability	(0.2)	
	13.2	
Non-controlling interest (25%)		3.3
		15.3
Net assets acquired		(13.2)
Goodwill		2.1

Notes

1 It is assumed that the market value (ie, fair value) of the loan stock issued to fund the purchase of the shares in Kono Ltd is equal to the price of £12 million. IFRS 3 requires goodwill to be calculated by comparing the consideration transferred plus the non-controlling interest, valued either at fair value or, in this case, as a percentage of net assets, with the fair value of the identifiable net assets of the acquired business or company.

2 Share capital and pre-acquisition profits represent the book value of the net assets of Kono Ltd at the date of acquisition. Adjustments are then required to this book value in order to give the fair value of the net assets at the date of acquisition. For short-term monetary items, fair value is their carrying value on acquisition.

3 The fair value of property, plant and equipment should be determined by market value or, if information on a market price is not available (as is the case here), then by reference to depreciated replacement cost, reflecting normal business practice. The net replacement cost (ie, £16.8m) represents the gross replacement cost less depreciation based on that amount, and so further adjustment for extra depreciation is unnecessary.

4 Raw materials are valued at their replacement cost of £4.2 million.

5 The rationalisation costs cannot be reported in pre-acquisition results under IFRS 3, as they are not a liability of Kono Ltd at the acquisition date.

6 The fair value of the loan is the present value of the total amount payable (principal and interest). The present value of the loan is the same as its par value.

7 The contingent liability should be included as part of the acquisition net assets of Kono even though it is not deemed probable and therefore has not been recognised in Kono's individual accounts. However, the disclosed amount is not necessarily the fair value at which a third party would assume the liability. If the probability is low, then the fair value is likely to be lower than £200,000.

Answer to Interactive question 4

IFRS 11 gives examples in the oil, gas and mineral extraction industries. In such industries companies may, say, jointly control and operate an oil or gas pipeline. Each company transports its own products down the pipeline and pays an agreed proportion of the expenses of operating the pipeline (perhaps based on volume). In this case the parties have rights to assets (such as exploration permits and the oil or gas produced by the activities).

A further example is a property which is jointly controlled, each venturer taking a share of the rental income and bearing a portion of the expense.

Answer to Interactive question 5

Consolidated statement of profit or loss for the year ended 30 June 20X9

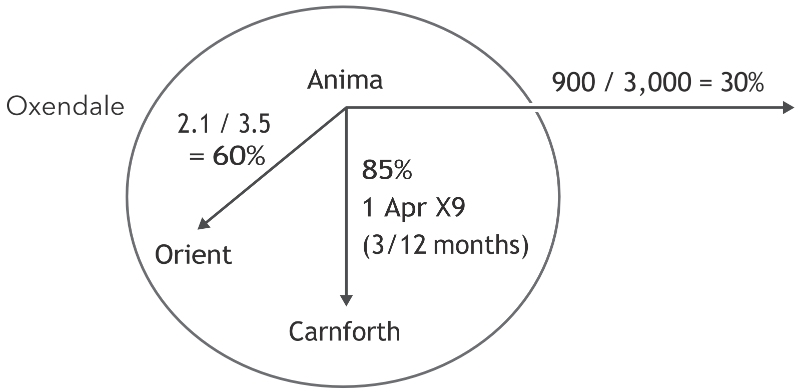
	£
Revenue (W2)	2,291,300
Cost of sales (W2)	(1,238,125)
Gross profit	1,053,175
Operating expenses (W2)	(263,980)
Profit from operations	789,195
Share of profits of associate (W6)	51,383
Profit before tax	840,578
Income tax expense (W2)	(240,685)
Profit for the year	599,893
Profit attributable to:	
Owners of Anima plc (Bal)	517,579
Non-controlling interest (W5)	82,314
	599,893

Consolidated statement of financial position (extract)

	£
Equity attributable to owners of Anima plc	
Ordinary share capital	4,000,000
Retained earnings (W7)	1,879,116
	5,879,116
Non-controlling interest (W8)	2,112,600
Total equity	7,991,716

WORKINGS

(1) **Group structure**



(2) **Consolidation schedule**

	Anima	**Orient**	**Carnforth**	**Adjustments**	**Total**
			3/12		
Revenue	1,410,500	870,300	160,000	(149,500)	2,291,300
Cost of sales					
Per question	(850,000)	(470,300)	(54,875)	149,500	(1,238,125)
PURP (W4)	(9,750)				
PURP (W4)	(2,700)				
Operating expenses					
Per question	(103,200)	(136,000)	(23,780)		(263,980)
Fair value adj (dep) (W3)			(1,000)		
Tax	(137,100)	(79,200)	(24,385)		(240,685)
PAT		184,800	55,960		

(3) **Fair value adjustment**

Additional fair value £320,000 Buildings £320,000 × 50% = £160,000

Additional depreciation charge in year £160,000 / 40 years × 3/12 months = £1,000

(4) **Unrealised profit**

Oxendale	**Orient**	**%**
207,000	149,500	115
(180,000)	(130,000)	(100)
27,000	19,500	15

Orient – £19,500 × ½ = £9,750 Oxendale – £27,000 × 1/3 = £9,000

Anima share of Oxendale PURP – £9,000 × 30% = £2,700

(5) Non-controlling interest

Orient Ltd (40% × £184,800 (W2)) = £73,920

Carnforth Ltd (15% × £55,960 (W2)) = £8,394

Non-controlling interest = £73,920 + £8,394 = £82,314

(6) Share of profits of associate

	£
Profit for the year	204,610
Anima share × 30%	61,383
Less impairment for year	(10,000)
	51,383

(7) Consolidated retained earnings

	£
Anima plc – c/fwd	1,560,000
Less PURP with Orient (W4)	(9,750)
Less PURP with Oxendale (W4)	(2,700)
Orient Ltd (60% × (580 – 195))	231,000
Carnforth Ltd (85% × 55,960) (W2)	47,566
Oxendale Ltd ((30% × (340 – 130)) – 10 (impairment))	53,000
	1,879,116

(8) Non-controlling interest – SFP

	£	£
Orient Ltd		
FV of NCI at acquisition date	1,520,000	
Share of post-acquisition reserves ((580 – 195) × 40%)	154,000	
		1,674,000
Carnforth Ltd		
Net assets per question	2,605,000	
Fair value adjustment (increase)	320,000	
Less extra depreciation on FV adj	(1,000)	
	2,924,000	
NCI – 2,924,000 × 15%		438,600
		2,112,600

CHAPTER 20

Answer to Interactive question 6

6.1 **Consolidated statement of financial position as at 31 March 20X4**

Assets	**£**	**£**
Non-current assets		
Property, plant and equipment		
(660,700 + 635,300 + 24,000 – 1,000 (W1) – 3,000 (W7))		1,316,000
Intangibles (101,300 + 144,475 (W2))		245,775
Investment in joint venture (W6)		93,600
		1,655,375
Current assets		
Inventories (235,400 + 195,900 – 2,400 (W5))	428,900	
Trade and other receivables (174,900 + 78,800 – 50,000)	203,700	
Cash and cash equivalents (23,700 + 11,900 + 10,000)	45,600	
		678,200
Total assets		2,333,575

Assets	**£**	**£**
Equity and liabilities		
Equity attributable to owners of Preston plc		
Ordinary share capital		100,000
Revaluation surplus		125,000
Retained earnings (W4)		1,099,550
		1,324,550
Non-controlling interest (W3)		190,025
Total equity Current liabilities		1,514,575
Trade and other payables (151,200 + 101,800 – 40,000)		
	213,000	
Taxation (85,000 + 80,000)	165,000	
Deferred consideration	441,000	
		819,000
Total equity and liabilities		2,333,575

WORKINGS

(1) **Net assets – Longridge Ltd**

	Year end	Acquisition	Post acq
	£	£	£
Share capital	500,000	500,000	
Retained earnings			
Per Q	312,100	206,700	
Less intangible (72,000 + 18,000)	(72,000)	(90,000)	
Fair value adj re PPE (120,000 – (92,000 × 48/46))	24,000	24,000	
Dep thereon (24,000 × 2/48)	(1,000)	–	
PPE PURP (W7)	(3,000)		
	760,100	640,700	119,400

(2) **Goodwill – Longridge Ltd**

	£
Consideration transferred (250,000 + (441,000 – 41,000 (W4)))	650,000
Non-controlling interest at acquisition (640,700 (W1) × 25%)	160,175
	810,175
Net assets at acquisition (W1)	(640,700)
	169,475
Impairment to date	(25,000)
	144,475

(3) **Non-controlling interest – Longridge Ltd**

	£
Non-controlling interest at acquisition (W2)	160,175
Share of post-acquisition reserves (119,400 (W1) × 25%)	29,850
	190,025

(4) **Retained earnings**

	£
Preston plc	1,084,800
Unwinding of discount on deferred consideration: Two years (441,000 – (441,000 / 1.05^2))	(41,000)
Less PURP (Longridge Ltd) (W5)	(2,400)
Longridge Ltd (119,400 (W1) × 75%)	89,550
Chipping Ltd (W6)	3,600
Less impairments to date (25,000 + 10,000)	(35,000)
	1,099,550

CHAPTER 20

(5) **Inventory PURPs**

		Chipping Ltd	Longridge Ltd
%		**£**	**£**
SP	100	15,000	12,000
Cost	(80)	(12,000)	(9,600)
GP	20	3,000	2,400

(6) **Investment in joint venture – Chipping Ltd**

	£	£
Cost		100,000
Add post-acquisition profits	12,000	
Less PURP (W5)	(3,000)	
	9,000	
× 40%		3,600
		103,600
Less impairment to date		(10,000)
		93,600

(7) **PPE PURP – Longridge Ltd.**

	£
Asset now in Preston plc's books at 15,000 × 1/3	5,000
	£
Asset would have been in Longridge Ltd's books at 10,000 × 1/5	(2,000)
	3,000

(8) **Goodwill journal entries**

		£	£
DEBIT	Intangibles – goodwill	39,160	
DEBIT	Share capital	320,000	
DEBIT	Retained earnings	112,300	
CREDIT	Investments		385,000
CREDIT	Non-controlling interest (320,000 + 112,300) × 20%		86,460

Answer to Interactive question 7

7.1 Goodwill (at date control obtained)

	$m	$m
Consideration transferred		480
NCI (20% × 750)		150
Fair value of previously held equity interest ($480m × 20/60)		160
Fair value of identifiable assets acquired and liabilities assumed		
Share capital	300	
Retained earnings	450	
		(750)
		40

7.2 Profit on derecognition of investment

	$m
Fair value at date control obtained (see part 1)	160
Cost	(120)
	40

Answer to Interactive question 8

8.1 Answer as follows:

(a) **Complete disposal at year end (80% to 0%)**

Consolidated statement of financial position as at 30 September 20X8

	Streatham	Balham	Adj 1	Adj 2	Disposal	Consolidated
	£'000	£'000	£'000	£'000	£'000	£'000
Non-current assets	360	270			(270)	360
Investment	324		(324)			
Goodwill			36		(36)	
Current assets	370	370			370 + 650	1,020
						1,380
Share capital	540	180	(180)			540
Reserves	414	360	(180)	(36)	182	740
NCI			72	36	(108)	–
Current liabilities	100	100			(100)	100
						1,380

CHAPTER 20

Consolidated statement of profit or loss for the year ended 30 September 20X8

	Streatham	Balham	Adj 1	Adj 2	Disposal	Consolidated
	£'000	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**
Profit before tax	153	126				279
Profit on disp'l					182	182
Tax	(45)	(36)				(81)
	108	90				380
Owners of parent	108	90		(18)	182	362
NCI				18		18
						380

Notes

1 The above consolidation schedules are prime examples of where the excel file should be used. For full marks to be awarded, the schedule must be added across correctly, and it is easier to do this using an excel file. It is important that you know which way round the adjustments go. You need to copy the schedule into the word-processing area and show your workings. The examiners have made it clear that the markers will not check formulae in the excel file cells so it is vital to make it clear where your figures have come from.

2 The above recommendation of using an excel file for consolidation adjustments also applies to questions which ask you to adjust financial statements to correct financial reporting treatments. Adjustments and totals are shown in rows and columns. Such questions are often a feature of Question 2 in the exam.

WORKINGS

(1) **Goodwill**

	£'000
Consideration transferred	324
NCI: 20% × (180 + 180)	72
	396
Net assets (180 + 180)	(360)
	36

Consolidation adjustment journal		**£'000**	**£'000**
DEBIT	Goodwill	36	
DEBIT	Share capital	180	
DEBIT	Reserves	180	
CREDIT	Investment		324
CREDIT	Non-controlling interest		72

To recognise the acquisition and related goodwill and non-controlling interest.

(2) **Allocate profits between acquisition date and disposal date to NCI**

	£
Post-acquisition profits (360 – 180)	180,000
NCI share (20%)	36,000

Of these, £18,000 (90,000 × 20%) relate to the current year.

Consolidation adjustment journal (SOFP)		**£'000**	**£'000**
DEBIT	Reserves	36	
CREDIT	Non-controlling interest		36

To allocate the NCI share of post-acquisition profits.

In addition, 20% of the profits of Balham Co arising in the year are allocated to the NCI:

Consolidation adjustment journal (SPL)		**£'000**	**£'000**
DEBIT	Profits attributable to owners of parent	18	
CREDIT	Non-controlling interest in profit		18

To allocate the NCI share of post-acquisition profits in the current year.

(3) **Profit on disposal of Balham Co**

	£'000	**£'000**
Fair value of consideration received		650
Less: net assets at disposal	540	
goodwill	36	
NCI (540 × 20%)	(108)	
		(468)
		182

Consolidation adjustment journal (SPL)		**£'000**	**£'000**
DEBIT	Cash	650	
DEBIT	NCI	108	
DEBIT	Disposal date liabilities of Balham	100	
CREDIT	Goodwill		36
CREDIT	Disposal date current assets of Balham		370
CREDIT	Disposal date non-current assets of Balham		270
CREDIT	Reserves		182

To recognise the group gain on disposal of Balham Co.

(b) **Partial disposal: subsidiary to subsidiary (80% to 60%)**

Consolidated statement of financial position as at 30 September 20X8

	Streatham	**Balham**	**Adj 1 (part (a))**	**Adj 2 (part (a))**	**Disposal**	**Consolid'd**
	£'000	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**
Non-current assets	360	270				630
Investment	324		(324)			
Goodwill			36			36
Current assets	370	370			160	900
						1,566
Share capital	540	180	(180)			540
Reserves	414	360	(180)	(36)	52	610
NCI			72	36	108	216
Current liabilit's	100	100				200
						1,566

Consolidated statement of profit or loss for the year ended 30 September 20X8

	Streatham	**Balham**	**Adj 1**	**Adj 2**	**Disposal**	**Consolid'd**
	£'000	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**
Profit before tax	153	126				279
Profit on disp'l						–
Tax	(45)	(36)				(81)
	108	90				198
Owners of parent	108	90		(18)		180
NCI				18		18
						198

WORKING

Disposal

Adjustment is made to equity as control is not lost.

	£'000
NCI before disposal 80% (360 + 180)	432
NCI after disposal 60% (360 + 180)	(324)
Required adjustment	108

Consolidation adjustment journal (SOFP)		**£'000**	**£'000**
DEBIT	Current assets (cash)	160	
CREDIT	NCI		108
CREDIT	Reserves		52

8.2 Answer as follows:

(a) **Partial disposal: subsidiary to associate (80% to 40%) Profit on disposal**

	£'000	£'000
Fair value of consideration received		340
Fair value of 40% investment retained		250
Less: Net assets when control lost		
(540 – (90 × 3/12))	517.5	
Goodwill (part (a))	36	
NCI (517.5 × 20%)	(103.5)	
		(450)
		140

Group reserves

	Streatham reserves £'000	Balham £'000	Balham 40% reserve £'000
At date of disposal	414		
Group profit on disposal (W1)	140		
Balham: share of post-acquisition earnings (157.5 × 80%)	126		
Balham: share of post-acquisition earnings (22.5 × 40%)	9		
	689		
At date of disposal (360 – (90 × 3/12))/per question	414	337.5	360.0
Retained earnings at acquisition/on disposal	414	(180.0)	(337.5)
		157.5	22.5

C H A P T E R 20

Investment in associate

	£'000
Fair value at date control lost (new 'cost')	250
Share of post-acquisition reserves (90 × 3/12 × 40%)	9
	259

(b) **Partial disposal: subsidiary to financial asset (80% to 40%) Profit on disposal** – as in part (a)

Group reserves

	£'000
Streatham Co's reserves	414
Group profit on disposal (W1)	140
Balham: share of post-acquisition reserves (157.5 (see below) × 80%)	126
	680

Balham

At date of disposal (360 – (90 × 3/12))	337.5
Reserves at acquisition	(180.0)
	157.5

Retained investment – at £250,000 fair value

Answer to Interactive question 9

Consolidated statement of cash flows for the year ended 31 December 20X8

	£'000	£'000
Cash flows from operating activities		
Cash generated from operations (Note 1)	340	
Income taxes paid (W4)	(100)	
Net cash from operating activities		240
Cash flows from investing activities		
Acquisition of subsidiary S Ltd, net of cash acquired (Note 2)	(90)	
Purchase of property, plant and equipment (W1)	(220)	
Net cash used in investing activities		(310)
Cash flows from financing activities		
Proceeds from issue of share capital (1,150 + 650 – 1,000 – 500 – (100 × £2))	100	
Dividend paid to non-controlling interest (W3)	(4)	
Net cash from financing activities		96
Net increase in cash and cash equivalents		26
Cash and cash equivalents at the beginning of period		50
Cash and cash equivalents at the end of period		76

Notes to the statement of cash flows

(1) Reconciliation of profit before tax to cash generated from operations

	£'000
Profit before taxation	420
Adjustments for:	
Depreciation	210
	630
Increase in trade receivables (1,370 – 1,100 – 30)	(240)
Increase in inventories (1,450 – 1,200 – 70)	(180)
Increase in trade payables (1,690 – 1,520 – 40)	130
Cash generated from operations	340

(2) Acquisition of subsidiary

During the period the group acquired subsidiary S Ltd. The fair values of assets acquired and liabilities assumed were as follows:

	£'000
Cash and cash equivalents	10
Inventories	70
Receivables	30
Property, plant and equipment	190
Trade payables	(40)
Non-controlling interest	(26)
	234
Goodwill	66
Total purchase price	300
Less cash of S Ltd	(10)
Less non-cash consideration	(200)
Cash flow on acquisition net of cash acquired	90

WORKINGS

(1) **PROPERTY, PLANT AND EQUIPMENT**

	£'000		**£'000**
b/f	2,300	Depreciation	210
On acquisition	190	c/f	2,500
Additions (balancing figure)	220		
	2,710		2,710

(2) **GOODWILL**

	£'000		**£'000**
b/f	–		

CHAPTER 20

	£'000		£'000
		Impairment losses (balancing	
Additions (300 – (90% × 260))	66	figure)	0
		c/f	66
	66		66

NON

(3) **NON-CONTROLLING INTEREST**

	£'000		£'000
Dividend			
Dividend (balancing figure)	4	b/f	–
c/f	31	On acquisition	26
		CSPL	9
	35		35

(4) **INCOME TAX PAYABLE**

	£'000		£'000
		b/f	100
Cash paid (balancing figure)	100	CSPL	150
c/f	150		
	250		250

Answer to Interactive question 10

(a) **Cash flows from investing activities**

	£'000
Disposal of subsidiary Desdemona Ltd, net of cash disposed of (400 – 20)	380

(b) **Cash flows from investing activities**

	£'000
Purchase of property, plant and equipment (W1)	(1,307)

(c) **Cash flows from financing activities**

	£'000
Dividends paid to non-controlling interest (W2)	(42)

(d) **Note to the statement of cash flows**

During the period the group disposed of subsidiary Desdemona Ltd. The book values of assets and liabilities disposed of were as follows:

	£'000
Cash and cash equivalents	20
Inventories	50
Receivables	39
Property, plant and equipment	390
Payables	(42)

	£'000
Non-controlling interest (W2)	(91)
	366
Profit on disposal	34
Total sale proceeds	400
Less cash of Desdemona Ltd disposed of	(20)
Cash flow on disposal net of cash disposed of	380

(e) **Reconciliation of profit before tax to cash generated from operations**

	£'000
Profit before tax (862 + 20)	882
Adjustments for:	
Depreciation	800
	1,682
Increase in receivables (605 – 417 + 39)	(227)
Increase in inventories (736 – 535 + 50)	(251)
Increase in payables (380 – 408 + 42)	14
Cash generated from operations	1,218

WORKINGS

(1) **PROPERTY, PLANT AND EQUIPMENT – CARRYING AMOUNT**

	£'000		£'000
b/f	3,950	c/f	4,067
Additions (balancing figure)	1,307	Disposal of sub	390
		Depreciation charge	800
	5,257		5,257

(2) **NON-CONTROLLING INTEREST**

	£'000		£'000
c/f	482	b/f	512
Disposal of sub (457 × 20%)	91	CSPL	103
Dividends to NCI			
(balancing figure)	42		
	615		615

Answer to Interactive question 11

11.1 Reasons for reviewing the work of component auditors

The main consideration which concerns the audit of all group accounts is that the holding company's auditors (the 'group' auditors) are responsible to the members of that company for the audit opinion on the whole of the group accounts.

It may be stated (in the notes to the financial statements) that the financial statements of certain subsidiaries have been audited by other firms, but this does not absolve the group auditors from any of their responsibilities.

The auditors of a holding company have to report to its members on the truth and fairness of the view given by the financial statements of the company and its subsidiaries dealt with in the group accounts. The group auditors should have powers to obtain such information and explanations as they reasonably require from the subsidiary companies and their auditors, or from the parent company in the case of overseas subsidiaries, in order that they can discharge their responsibilities as holding company auditors.

The auditing standard ISA (UK) 600 (Revised November 2019), *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* clarifies how the group auditors can carry out a review of the audits of subsidiaries in order to satisfy themselves that, with the inclusion of figures not audited by themselves, the group accounts give a true and fair view.

The scope, standard and independence of the work carried out by the auditors of subsidiary companies (the 'component' auditors) are the most important matters which need to be examined by the group auditors before relying on financial statements not audited by them. The group auditors need to be satisfied that all material areas of the financial statements of subsidiaries have been audited satisfactorily and in a manner compatible with that of the group auditors themselves.

11.2 Procedures to be carried out by group auditors in reviewing the component auditors' work

(1) Send a questionnaire to all other auditors requesting detailed information on their work, including:

  (a) An explanation of their general approach (in order to make an assessment of the standards of their work)

  (b) Details of the accounting policies of major subsidiaries (to ensure that these are compatible within the group)

  (c) The component auditors' opinion of the subsidiaries' overall level of internal control, and the reliability of their accounting records

  (d) Any limitations placed on the scope of the auditors' work

  (e) Any qualifications, and the reasons for them, made or likely to be made to their audit reports

(2) Carry out a detailed review of the component auditors' working papers on each subsidiary whose results materially affect the view given by the group financial statements. This review will enable the **group** auditors to ascertain whether (inter alia):

  a. An up to date permanent file exists with details of the nature of the subsidiary's business, its staff organisation, its accounting records, previous year's financial statements and copies of important legal documents.

b. The systems examination has been properly completed, documented and reported on to management after discussion.

c. Tests of controls and substantive procedures have been properly and appropriately carried out, and audit programmes properly completed and signed.

d. All other working papers are comprehensive and explicit.

e. The overall review of the financial statements has been adequately carried out, and adequate use of analytical procedures has been undertaken throughout the audit.

f. The financial statements agree in all respects with the accounting records and comply with all relevant legal requirements and accounting standards.

g. Minutes of board and general meetings have been scrutinised and important matters noted.

h. The audit work has been carried out in accordance with approved auditing standards.

i. The financial statements agree in all respects with the accounting records and comply with all relevant legal and professional requirements.

j. The audit work has been properly reviewed within the firm of auditors and any laid-down quality control procedures adhered to.

k. Any points requiring discussion with the holding company's management have been noted and brought to the **group** auditors' attention (including any matters which might warrant a modification in the audit report on the subsidiary company's financial statements).

l. Adequate audit evidence has been obtained to form a basis for the audit opinion on both the subsidiaries' financial statements and those of the group.

If the **group** auditors are not satisfied as a result of the above review, they should arrange for further audit work to be carried out either by the component auditors on their behalf, or jointly with them. The component auditors are fully responsible for their own work; any additional tests are those required for the purpose of the audit of the group financial statements.

Answer to Interactive question 12

12.1 Intra-group balances should agree because, in the preparation of consolidated accounts, it is necessary to cancel them out. If they do not cancel out then the group accounts will be displaying an item which has no value outside of the group and profits may be correspondingly under- or overstated. The audit procedures required to check that intra-group balances agree would be as follows.

(1) Obtain and review a copy of the parent company's instructions to all group members relating to the procedures for reconciliation and agreement of year-end intra-group balances. Particular attention should be paid to the treatment of 'in transit' items to ensure that there is a proper cut-off.

(2) Obtain a schedule of intra-group balances from all group companies and check the details therein to the summary prepared by the parent company. The details on these schedules should also be independently confirmed in writing by the other auditors involved.

(3) Nil balances should also be confirmed by both the group companies concerned and their respective auditors.

(4) The details on the schedules in (2) above should also be agreed to the details in the financial statements of the individual group companies which are submitted to the parent company for consolidation purposes.

12.2 Where one company in a group supplies goods to another company at cost plus a percentage, and such goods remain in inventory at the year end, then the group inventory will contain an element of unrealised profit. In the preparation of the group accounts, best accounting practice requires that an allowance should be made for this unrealised profit.

In order to verify that intra-group profit in inventory has been correctly accounted for in the group accounts, the audit procedures required would be as follows.

(1) Confirm the group's procedures for identification of such inventory and their notification to the parent company who will be responsible for making the required provision.

(2) Obtain and review schedules of intra-group inventory from group companies and confirm that the same categories of inventory have been included as in previous years.

(3) Select a sample of invoices for goods purchased from group companies and check to see that these have been included in year-end intra-group inventory as necessary and obtain confirmation from component auditors that they have satisfactorily completed a similar exercise.

(4) Check the calculation of the allowance for unrealised profit and confirm that this has been arrived at on a consistent basis with that used in earlier years, after making due allowance for any known changes in the profit margins operated by various group companies.

(5) Check the schedules of intra-group inventory against the various inventory sheets and consider whether the level of intra-group inventory appears to be reasonable in comparison with previous years, ensuring that satisfactory explanations are obtained for any material differences.

Answers to Self-test questions

1 Burdett

Goodwill: £380,000

Excess of assets/liabilities over cost of combination: Nil

	Swain	Thamin
	£'000	£'000
Consideration transferred	1,340	340
NCI (20% × £1.2m) / (40% × £680,000)	240	272
	1,580	612
Net assets of acquiree	(1,200)	(680)
Goodwill / Gain on bargain purchase	380	(68)

See IFRS 3.32 and 34. The second acquisition resulted in an excess over the cost of combination which should be recognised immediately in profit.

2 Sheliak

Depreciation charge: decrease by £10,000 Carrying amount: decrease by £30,000

Depreciation charge: Sheliak (£1m / 8 years)	£125,000
Parotia (£575,000 / 5 years)	£115,000
Decrease	£10,000
Carrying amount: Sheliak (£1m × 3/8 years)	£375,000
Parotia (£575,000 × 3/5 years)	£345,000
Decrease	£30,000

Fair value adjustments not reflected in the books must be adjusted for on consolidation. In this example the depreciation is decreased by the difference between Sheliak's depreciation charge and Parotia's fair value depreciation calculation. The carrying amount is decreased by the difference between Sheliak's carrying value at 31 December 20X7 and Parotia's carrying value at 31 December 20X7.

3 Finch

£207,000

	£'000
Net assets per SFP (£8.1m – £1.3m)	6,800
Fair value adjustment to property	300
Contingent liability	(20)
Adjusted net assets	7,080

Net assets is increased by the fair value adjustment of £300,000 and decreased by the contingent liability, which is recognised in accordance with IFRS 3.23.

Goodwill is therefore calculated as:

	£'000
Consideration transferred	5,100
Non-controlling interest	
Ordinary shares 15% × (£7.08m – £2.5m)	687
Preference shares 60% × £2.5m	1,500
	7,287
Net assets of acquiree	(7,080)
Goodwill	207

4 Maackia

£1,780,000

	£'000	£'000
Consideration transferred		4,800
Non-controlling interest (fair value)		1,800
6,600		
Net assets of acquiree		
Draft	4,600	
Business held for sale ((£760,000 – £40,000) – £500,000)	220	
		(4,820)
Goodwill		1,780

In allocating the cost of the business combination to the assets and liabilities acquired, the business that is on the market for immediate sale should be valued in accordance with IFRS 5 at fair value less costs to sell (IFRS 3.31).

The defined benefit plan net asset should be recognised in accordance with IAS 19 (IFRS 3.26).

5 Gibbston

(a) £4.9m

	£'000	£'000
Consideration transferred: Cash		15,000
Deferred cash (£5.5m/1.1)		5,000
Contingent cash (£13.3m/1.1^3) × 45%		4,500
		24,500
Non-controlling interest: Net assets at 1 Jan 20X7	20,000	
Loss to acquisition (£3m × 4/12)	(1,000)	
Fair value adjustment	9,000	
30% ×	28,000	8,400
		32,900

	£'000	£'000
Net assets of acquiree		(28,000)
Goodwill		4,900

IFRS 3.39 requires contingent consideration capable of reliable measurement to be included at fair value regardless of whether payment is probable.

The net assets at the acquisition date are those at the start of the year adjusted for the fair value increase of plant (£9m) less the losses between the start of the year and the acquisition date.

(a) £1.2m share of loss

	£m
Non-controlling interest share of loss:	
Loss: Acquisition to 31 December (8/12 × £3m)	2
Extra depreciation (£9m/3 years × 8/12)	2
	4 × 30% = £1.2m

(b) £7.2m

	£m
Non-controlling interest in SFP	
Share of the net assets at the date of acquisition (£28m × 30%)	8.4
Share of loss since acquisition (part (b))	(1.2)
	7.2

6 Supermall

Supermall has been set up as a separate vehicle. As such, it could be either a joint operation or joint venture, so other facts must be considered.

There are no facts that suggest that the two real estate companies have rights to substantially all the benefits of the assets of Supermall or an obligation for its liabilities.

Each party's liability is limited to any unpaid capital contribution.

As a result, each party has an interest in the net assets of Supermall and should account for it as a joint venture using the equity method in accordance with IFRS 11, *Joint Arrangements*.

7 Green and Yellow

Orange

Green wishes to account for its arrangement with Yellow using the equity method. It can only do so if the arrangement meets the criteria in IFRS 11, *Joint Arrangements* for a **joint venture**.

A **joint arrangement** is an arrangement, as here, of which two or more parties have joint control. A **joint venture** is a joint arrangement whereby the parties that have control of the arrangement have **rights to the net assets** of the arrangement.

Orange is a **separate vehicle**. As such, it could be either a joint operation or joint venture, so other facts must be considered.

There are no facts that suggest that Green and Yellow have rights to substantially all the benefits of the assets of Orange or an obligation for its liabilities.

Each party's liability is limited to any unpaid capital contribution.

As a result, each party has an interest in the **net assets** of Orange and should account for it as a **joint venture** using the **equity method.**

Pipeline

Since Green has joint control over the pipeline, even though its interest is only 10%, it would not be appropriate to show the pipeline as an investment. This is a **joint arrangement** under IFRS 11.

The pipeline is a **jointly controlled asset**, and it is **not structured through a separate vehicle**. Accordingly, the arrangement is a **joint operation**.

IFRS 11, *Joint Arrangements* requires that a joint operator **recognises line by line the following** in relation to its interest in a joint operation:

(1) Its **assets**, including its share of any jointly held assets

(2) Its **liabilities**, including its share of any jointly incurred liabilities

(3) Its **revenue** from the sale of its share of the output arising from the joint operation

(4) Its **share of the revenue from the sale of the output** by the joint operation, and

(5) Its **expenses**, including its share of any expenses incurred jointly

This treatment is applicable in both the separate and consolidated financial statements of the joint operator.

8 Stuhr

£6,600,000

	£'000
Consideration transferred	10,000
Non-controlling interest (fair value)	2,000
Fair value of retained interest	3,000
	15,000
Fair value of net assets of Bismuth	(8,400)
Goodwill	6,600

9 Fleurie

There is no loss of control and therefore:

- no gain or loss arises on disposal of the 15% holding in Merlot; and
- there is no change to the carrying value of goodwill.

Instead, the transaction is accounted for in shareholders' equity, with any difference between proceeds and the change in the non-controlling interest being recognised in retained earnings.

The non-controlling interest before disposal is the fair value at acquisition plus the fair value of post- acquisition reserves to the date of disposal, as represented by change in net assets:

	£
Fair value at acquisition	350,000
Share of post-acquisition reserves [(£3.5m – £2.2m) × 15%)]	195,000
	545,000
Increase in NCI: 15%/15%	545,000
NCI after change: 30%	1,090,000

The non-controlling interest has therefore increased by £545,000, recorded by:

DEBIT	Cash proceeds	£560,000	
CREDIT	NCI		£545,000
CREDIT	Retained earnings		£15,000

10 Chianti

On disposal of Barolo, the consolidated statement of profit or loss and other comprehensive income will include a gain on disposal of £6,000 (as calculated below).

The group share of the revaluation surplus recognised by Barolo is not reclassified into profit or loss but is transferred from the group revaluation reserve to group retained earnings.

	£	£
Proceeds		340,000
Fair value of interest retained		20,000
		360,000
Net assets	320,000	
Goodwill (£70,000 – £20,000)	50,000	
NCI (5% × 320,000)	(16,000)	
		(354,000)
Gain on disposal		6,000

11 Porter

Porter Group statement of cash flows for the year ended 31 May 20X6

	£m	£m
Cash flows from operating activities		
Profit before taxation	112	
Adjustments for:		
Depreciation	44	
Impairment losses on goodwill (W2)	3	
Foreign exchange loss (W8)	2	

	£m	£m
Investment income – share of profit of associate	(12)	
Investment income – gains on financial assets at fair value through profit or loss	(6)	
Interest expense	16	
	159	
Increase in trade receivables (132 – 112 – 16)	(4)	
Decrease in inventories (154 – 168 – 20)	34	
Decrease in trade payables (110 – 98 – 12 – (W8) 17 PPE payable)	(17)	
Cash generated from operations	172	
Interest paid (W7)	(12)	
Income taxes paid (W6)	(37)	
	£m	**£m**
Net cash from operating activities		123
Cash flows from investing activities		
Acquisition of subsidiary, net of cash acquired (26 – 8)	(18)	
Purchase of property, plant and equipment (W1)	(25)	
Purchase of financial assets (W4)	(10)	
Dividend received from associate (W3)	11	
Net cash used in investing activities		(42)
Cash flows from financing activities		
Proceeds from issuance of share capital (332 + 212 – 300 – 172 – (80 × 60%/2 × £2.25))	18	
Proceeds from long-term borrowings (380 – 320)	60	
Dividend paid	(45)	
Dividends paid to non-controlling interests (W5)	(4)	
Net cash from financing activities		29
Net increase in cash and cash equivalents		110
Cash and cash equivalents at the beginning of the year		48
Cash and cash equivalents at the end of the year		158

WORKINGS

(1) **Additions to property, plant and equipment**

PROPERTY, PLANT AND EQUIPMENT

	£m		£m
b/d			
Revaluation	58	Depreciation	44
Acquisition of subsidiary	92		
Additions on credit (W8)	15		
∴ Additions for cash	25	c/d	958
	1,002		1,002

(2) **Impairment losses on goodwill**

GOODWILL

	£m		£m
b/d	10		
Acq'n of subsidiary [(80 × 60%/2 × 2.25) + 26 + (120 × 40%) – 120 net assets]	8	∴ Impairment losses	3
		c/d	15
	18		18

(3) **Dividends received from associate**

INVESTMENT IN ASSOCIATE

	£m		£m
b/d	39		
P/L	12	∴ Dividends received	11
OCI	8		
		c/d	48
	59		59

(4) **Purchase of financial assets**

FINANCIAL ASSETS AT FAIR VALUE THROUGH PROFIT OR LOSS

	£m		£m
b/d	0		
P/L	6		
∴ Additions	10		
		c/d	16
	16		16

(5) **Dividends paid to non-controlling interests**

NON-CONTROLLING INTERESTS

	£m		£m
		b/d	28
∴ Dividends paid	4	TCI	12
c/d	84	Acquisition of subsidiary (120 × 40%)	48
	88		88

(6) **Income taxes paid**

INCOME TAX PAYABLE

	£m		£m
		b/d (deferred tax)	26
		b/d (current tax)	22
		P/L	34
∴ Income taxes paid	37	OCI	17
c/d (deferred tax)	38	Acquisition of subsidiary	4
c/d (current tax)	28		
	103		103

(7) **Interest paid**

INTEREST PAYABLE

	£m		£m
		b/d	4
		P/L	16
∴ Interest paid	12		
c/d	8		
	20		20

(8) **Foreign currency transaction**

Transactions recorded on:

		£m	£m
(1) **5 March**			
DEBIT	Property, plant and equipment (102m/6.8)	15	
CREDIT	Payables		15
(2) **31 May**	Payable = 102m/6.0 = £17m		
DEBIT	P/L (Admin expenses)	2	
CREDIT	Payables (17 – 15)		2

12 Tastydesserts

Consolidated statement of cash flows for the year ended 31 December 20X2

	£'000	£'000
Cash flows from operating activities		
Profit before taxation	666	
Adjustments for:		
Depreciation	78	
Share of profit of associates	(120)	
Interest expense		
	624	
Increase in receivables (2,658 – 2,436 – 185)	(37)	
Increase in inventories (1,735 – 1,388 – 306)	(41)	
Increase in payables (1,915 – 1,546 – 148)	221	
Cash generated from operations	767	
Interest paid	–	
Income taxes paid (W5)	(160)	
Net cash from operating activities		607
Cash flows from investing activities		
Acquisition of subsidiary Custardpowders net of cash acquired (55 – 7)	(48)	
Purchase of property, plant and equipment (W1)	463)	
Dividends received from associates (W3)	100	
Net cash used in investing activities		(411)
Cash flows from financing activities		
Dividends paid	(63)	
Net cash used in financing activities		(63)
Net increase in cash and cash equivalents		133
Cash and cash equivalents at beginning of year		(266)
Cash and cash equivalents at end of year		(133)

WORKINGS

(1) **Purchase of property, plant and equipment**

PROPERTY, PLANT AND EQUIPMENT

	£'000		£'000
b/d	3,685		
Acquisition of Custardpowders	694	Depreciation	78
∴ Cash additions	463	c/d	4,764
	4,842		4,842

CHAPTER 20

(2) **Goodwill**

GOODWILL

	£'000		£'000
b/d	–		
Acquisition of Custardpowders	42	∴ Impairment losses	0
(1,086 – (1,044 × 100%))		c/d	42
	42		42

(3) **Dividends received from associates**

INVESTMENT IN ASSOCIATE

	£'000		£'000
b/d	2,175		
Share of profit	120	∴ Dividends received	100
		c/d	2,195
	2,295		2,295

(4) **Reconciliation of share capital**

	£'000
Share capital plus premium b/d	4,776
Issued to acquire sub (120,000 × £2.80)	336
	£'000
Share capital plus premium c/d (4,896 + 216)	5,112

∴ no shares have been issued for cash during the year.

(5) **Income taxes paid**

INCOME TAX PAYABLE

	£'000		£'000
		b/d - current tax	200
		- deferred tax	180
∴ Cash paid	160	P/L	126
c/d- current tax	235		
- deferred tax	111		
	506		506

Chapter 21

Foreign currency translation and hyperinflation

Introduction

Learning outcomes

- Determine and calculate how exchange rate variations are recognised and measured and how they can impact on reported performance, position and cash flows of single entities and groups
- Demonstrate, explain and appraise how foreign exchange transactions are measured and how the financial statements of foreign operations are translated
- Justify and conclude for a particular scenario what comprises sufficient, appropriate audit evidence
- Design and determine audit procedures in a range of circumstances and scenarios, for example identifying an appropriate mix of tests of controls, analytical procedures and tests of details
- Demonstrate and explain, in the application of audit procedures, how relevant ISAs affect audit risk and the evaluation of audit evidence
- Appraise corporate reporting policies, estimates and measurements for single entities and groups in the context of an audit

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
1	**Objective and scope of IAS 21** The management of foreign exchange risk is an important aspect of business operations. There are two aspects to IAS 21: • Buying and selling goods overseas priced in a foreign currency • Translating the financial statements of a foreign subsidiary before consolidation.	**Approach** This short section is an introduction to the topic. You must understand the difference between monetary and non-monetary items in this section. Pay particular attention to paragraph 1.3: summary of approach. **Stop and think** The first, but not the second of the two aspects identified, will be familiar to	This section would not be examined directly, but you would need to be able to **apply** the approach.	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
		you from your earlier studies.		
2	**The functional currency** In a working context you may have to establish the functional currency, and determine the accounting treatment of exchange differences on monetary and non-monetary items.	**Approach** Learn and try to remember the primary and secondary indicators of functional currency. Then carefully go through worked example 1. **Stop and think** The functional currency of an entity may not be obvious.	Functional currency comes up a lot, in the context of buying and selling goods overseas, group accounts and hedging. It has also come up in an audit context and in conjunction with deferred tax.	N/A There are no interactive questions in this section. However, you can test yourself by covering up the solution to worked example 2.
3	**Reporting foreign currency transactions** Importing and exporting goods introduces foreign exchange risk and results in earnings volatility with reporting implications on earnings and cash flow.	**Approach** You have covered this area in your FAR studies, but only at Level C. Read through Sections 3.1 (initial measurement), 3.2 (subsequent measurement) and 3.3 (recognition of exchange differences) focusing on the worked examples. **Stop and think** What is a monetary item?	While this topic comes up fairly regularly, in an exam you are more likely to get foreign currency transactions in the context of a group, since this was not covered at Professional Level.	**IQ2: Rumble plc** This question on buying and selling goods from a foreign supplier covers a similar transaction in four different scenarios.
4	**Foreign currency translation of financial statements** IAS 21 contains rules for the translation of financial statements of a foreign operation from the functional currency to the presentation currency.	**Approach** Focus on the translation rules in paragraph 4.1. You will need to learn these. Then learn the reasons for and treatment of exchange differences in paragraph 4.2. The worked example is comprehensive and needs to be studied carefully.	You may meet a situation where the wrong exchange rate has been used, and asked to give advice as to the correct one, possibly in an auditing or ethics context.	**IQ4: Translation of a foreign operation** An introductory question to practise the basics before going on to full consolidation.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
		Stop and think What rate do you use to translate equity?		
5	**Foreign currency and consolidation** This section deals with the accounting requirements for reporting of foreign transactions, consolidation of foreign subsidiaries and goodwill and fair value adjustments.	**Approach** Remind yourself of the translation rules using the summary in 5.1. The main issue is what to do with the exchange differences on consolidation. The worked example Darius is very comprehensive. **Stop and think** Why do exchange differences arise? How is goodwill translated?	You may be required to prepare consolidated financial statements involving an overseas subsidiary, but you are also likely to have to adjust them. Remember that although the foreign currency aspect appears complex, these consolidations have much in common with ordinary consolidations.	N/A Although there are no full interactive questions in this section, you can use the worked examples by covering up the solution and also practise a full FX consolidation using self-test question 14.
6	**Disclosure** The disclosure requirements of IAS 21 are not particularly onerous.	**Approach** Read through and highlight. **Stop and think** What should be disclosed where there is a change in the functional currency?	Disclosures have not yet been examined.	N/A
7	**Other matters** The most important issue in this section is the treatment of non-controlling interest.	**Approach** Note that the calculation of non-controlling interest, including the exchange rate, varies according to whether full goodwill or partial goodwill is used. **Stop and think** How is the non-controlling interest in profit or loss arrived at?	This topic could come up as a discussion point, for example, the impact of any future changes in exchange rates on the consolidated financial statements.	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
8	**Reporting foreign currency cash flows** This section covers the impact of foreign currency on statements of cash flows.	**Approach** The main point is that the cash flows and transactions should be translated into the entity's functional currency at the transaction date. **Stop and think** Although the translation of foreign currency amounts does not affect the cash flow of an entity, translation differences relating to cash and cash equivalents are part of the changes in cash and cash equivalents during a period.	Foreign currency cash flows are likely to be examined in the context of hedging (see Chapter 17).	N/A Although there are no full interactive questions in this section, you can practise this topic using self-test question 15.
9	**Reporting in hyperinflationary economies** Until recently the levels of general inflation in G7 and developed countries have been low, so the management and reporting of inflationary price rises has not been a major challenge to investors and the users of financial statements.	**Approach** Read through quickly and audit the worked example. Key point: the financial statements of a foreign operation operating in a hyperinflationary economy must be adjusted under IAS 29 before they are translated into the parent's reporting currency and then consolidated. **Stop and think** This topic is only examinable at Level D, so is not a major priority compared with IAS 21.	This standard has not yet been examined.	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
10	**Audit focus** The audit of foreign subsidiaries was considered in Chapter 20. This section gives some further points and a full exam-style integrated question.	**Approach** Foreign subsidiaries introduce additional risks because the parent may have less control. Additional audit procedures are therefore needed. **Stop and think** Which calculations would you need to check/re-perform?	The integrated nature of the Corporate Reporting exam means that the audit may give rise to a financial reporting issue relating to IAS 21. Alternatively, the financial reporting of foreign currency transactions may give rise to a discussion of audit risk and procedures.	**IQ5: Overseas subsidiary** This question asks for the risks that the auditor must take into account, both with the financial statements of the overseas subsidiary and the group financial statements.

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Objective and scope of IAS 21

Section overview

This section provides an overview of the objective, scope and main definitions of IAS 21, *The Effects of Changes in Foreign Exchange Rates*.

IAS 21 deals with two situations where foreign currency impacts financial statements:

(a) **An entity which buys or sells goods overseas, priced in a foreign currency**

A UK company might buy materials from Canada, pay for them in Canadian dollars, then sell its finished goods in Germany, receiving payment in euros or some other currency. If the company owes money in a foreign currency at the end of the accounting year or holds assets bought in a foreign currency, the assets and related liabilities must be translated into the local currency (in this case pounds sterling), in order to be shown in the books of account.

(b) **The translation of foreign currency subsidiary financial statements before consolidation**

A UK company might have a subsidiary abroad (ie, a foreign entity that it owns), and the subsidiary will trade in its own local currency. The subsidiary will keep books of account and prepare its annual financial statements in its own currency. However, at the year end, the parent company must 'consolidate' the results of the overseas subsidiary into its group accounts.
Therefore the assets and liabilities and the annual profits of the subsidiary must be translated from the foreign currency into pounds sterling.

If foreign currency exchange rates remained constant, there would be no accounting problem in either of these situations. However, foreign exchange rates are continually changing, sometimes significantly, between the start and the end of the accounting year. For example, in 2010 the British pound was strong against the euro, as a result of the problems in the Eurozone. It weakened in 2011, strengthened again by late 2012, then weakened in early 2013. By 2015 it had strengthened again.

1.1 Objective of IAS 21

An entity may carry on foreign activities in either of the two ways outlined above.

In either case, currency fluctuations will affect the financial position of the entity, when foreign currency transactions or items are translated into the entity's reporting currency.

The objective of IAS 21 is to produce rules that entities should follow in the translation of foreign currency activities.

1.2 Scope of IAS 21

IAS 21 applies in the following cases.

- In accounting for transactions and balances in foreign currencies except for those derivative transactions and balances that are within the scope of IFRS 9, *Financial Instruments*
- In translating the results and financial position of foreign operations that are included in the financial statements of the entity by consolidation or the equity method
- In translating an entity's results and financial position into a presentation currency

Definitions

Foreign currency: A currency other than the functional currency of the entity.

Functional currency: The currency of the primary economic environment in which the entity operates.

Presentation currency: The currency in which the financial statements are presented.

Exchange rate: The ratio of exchange for two currencies. **Closing rate:** The spot exchange rate at the reporting date. **Spot exchange rate:** The exchange rate for immediate delivery.

Exchange difference: The difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

Monetary items: Units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.

Group: A parent and all its subsidiaries.

Foreign operations: Defined as any subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.

Net investment in a foreign operation: The amount of the reporting entity's interest in the net assets of that operation.

1.3 Summary of approach required by the standard

For the preparation of financial statements, an entity needs to determine its **functional currency**. This is discussed in section 2 below. For group financial statements, there is no requirement for a group functional currency; each entity within a group can have its own functional currency.

When an entity enters into a transaction denominated in a currency other than its own functional currency, then it must translate the foreign currency items into its own functional currency according to IAS 21. This is covered in section 3.

When transactions create assets and liabilities that remain outstanding at the reporting date, then these items need to be translated into the entity's functional currency following the provisions of IAS 21. This is discussed in section 3.

Where a reporting entity comprises a number of individual entities, some of them with their own functional currencies, it is necessary for the constituent entities to translate their results into the **presentation currency** of the parent, in order to be included in the reporting entity's financial statements. This is covered in sections 4 and 5.

Section 6 deals with **disclosures** for foreign currency transactions.

2 The functional currency

Section overview

This section defines the functional currency of an entity and discusses the criteria that need to be met for a currency to be adopted by an entity as its functional currency.

2.1 Determining functional currency

Each entity, whether an individual company, a parent of a group, or an operation within a group (such as a subsidiary, associate or branch), should determine its **functional currency** and **measure its results and financial position in that currency**.

The functional currency is the currency of the primary economic environment in which the entity operates and it is normally the currency in which the entity primarily generates and expends cash.

Where an entity is registered in a particular national jurisdiction and the majority of its transactions take place there, that jurisdiction's currency will be the entity's functional currency. In practice, many entities operate internationally, with group entities or business divisions located worldwide. In such circumstances, management will be required to make a reasoned judgement in respect of each entity/division, based on the available facts.

Where the functional currency of an entity is not obvious, an explanation of why a particular currency was identified as being its functional currency would aid users' understanding of the business operations of the entity.

2.2 Indicators of functional currency

Under IAS 21, the management of a company needs to determine the functional currency of the company by assessing various indicators of the economic environment in which the company operates. IAS 21 provides **primary** and **secondary** indicators for use in the determination of an entity's functional currency, as summarised below.

Primary indicators

- The currency that mainly **influences sales prices** for goods and services (often the currency in which prices are denominated and settled)
- The currency of the **country whose competitive forces and regulations** mainly determine the sales prices of its goods and services
- The currency that mainly **influences labour, material and other costs** of providing goods or services (often the currency in which prices are denominated and settled)

Secondary indicators

- The currency in which **funds from financing activities** (raising loans and issuing equity) are generated
- The currency in which **receipts from operating activities** are usually retained

2.3 Functional currency of foreign operations

In addition to the five indicators mentioned above, four additional factors are considered in determining the functional currency of a foreign operation and whether its functional currency is the same as that of the reporting entity.

- Whether the foreign operation carries out its business as though it were an **extension of the reporting entity** rather than with a significant degree of autonomy
- Whether **transactions with the parent** are a high or low proportion of the foreign operation's activities
- Whether **cash flows** from the activities of the foreign operation **directly affect the cash flows of the parent** and are readily available for remittance to it
- Whether cash flows from the activities of the foreign operation are sufficient to service existing and normally expected debt obligations without funds being made available by the reporting entity

Worked example: Functional currency determination 1

Bogdankur, a small food processing company located in Denmark, is trading almost exclusively with Germany where the currency is the euro. The management of the company needs to decide on the functional currency of the company, ie, whether to use the Danish krone or the euro, and is using the following information (amounts are denominated in krone except as indicated).

Denominated in

		€	Settled in €
	€m	%	%
Revenue			
Export sales	750	100	100
Domestic sales	250	0	0
Total revenues	1,000	75	75
Materials	450	15	
Energy and gas	80		
Staff costs	80		
Other production expenses	30		
Depreciation	40		

		Denominated in €	Settled in €
	€m	%	%
Selling, general and administrative expenses	60	16	
Capital expenditure	70		
Dividends	180		

The main monetary assets and liabilities at 31 December 20X6 were as follows:

		Held in €	Expressed in €
	€m	%	%
Cash	120	90	
Total accounts receivable	140	80	
Trade payables	170	–	0
Borrowings	400	10	

Requirement

How might the management of the company determine the functional currency?

Solution

The management of the company has decided using the guidance provided by the IFRS to adopt the Danish krone as its functional currency, based on the fact that while the currency that influences sales prices is the euro, the domestic currency influences costs and financing.

Worked example: Functional currency determination 2

Entity A operates an oil refinery in Nigeria. All of the entity's income is denominated in US dollars, as oil trades in US dollars globally. About 20% of its operational expenses are dollar-denominated salaries and another 25% is imports of equipment denominated in US dollars. The remaining 55% of the operational expenses are incurred in Nigeria and are denominated in Naira. Depreciation costs are denominated in US dollars since the initial investment was in US dollars.

Requirement

What is the appropriate functional currency for Entity A?

Solution

The currency that mainly influences sales prices is the dollar. The currency that mainly influences costs is not clear, as 55% of the operational costs are in Naira and 45% are in US dollars. Depreciation should not be taken into account, because it is a non-cash cost, and the economic environment is where an entity generates and expenses cash.

Since the revenue side is influenced primarily by the US dollar and the cost side is influenced by both the dollar and the Naira, management will be justified on the basis of IAS 21 guidance to determine the US dollar as its functional currency.

Professional skills focus: Concluding, recommending and communicating

You may be required to determine the functional currency of an entity. It is important to communicate your arguments clearly, so that you will still get some credit even if you come to the wrong conclusion.

2.4 Change of functional currency

An entity's functional currency may change when its business operations change, leading to a different primary economic environment being identified. This is not a change in accounting policy, but instead results from a change in circumstances, and therefore the new functional currency should be adopted prospectively from the date of that change. The new functional currency is applied by retranslating all items and comparative amounts into the new currency at the date of the change in circumstances. The carrying amounts of non-monetary items translated into the new currency at the date of change should be deemed to be their historical translated amounts.

Worked example: Change in functional currency

An entity commenced trading many years ago in Belgium, using the euro (€) as its functional currency. After a number of years the entity started exporting its products to the UK, invoicing sales in UK pounds. Several years later the entity set up a branch in the UK as a small manufacturing function, incurring expenses and receiving sales proceeds in pounds sterling (£). With a fall in demand in Belgium by the end of 20X6 its activity in the UK came to represent 75% of the entity's activity.

Early in 20X7, the entity's management concluded that the UK was now its primary economic environment, with 1 January 20X8 being the date when the entity's functional currency changed from the euro to the pound.

The entity's equity and net assets at 31 December 20X7 were €80,000,000 and the exchange rate was £1: €1.59.

Requirement

How might the change be reflected in the financial statements?

Solution

The entity's equity and net assets were £50,314,465 when the pound sterling became its functional currency.

Where an entity's functional currency has changed as a result of changes in its trading operations during a period, the entity is required to disclose that the change has arisen, along with the reason for the change.

2.5 Functional currency of a hyperinflationary economy

If the functional currency is the currency of a hyperinflationary economy, the entity's financial statements are restated in accordance with IAS 29, *Financial Reporting in Hyperinflationary Economies* (covered later in this chapter). An entity cannot avoid restatement in accordance with IAS 29 by, for example, adopting as its functional currency a currency other than the functional currency determined in accordance with IAS 21.

3 Reporting foreign currency transactions

Section overview

This section deals with the IAS 21 rules governing the initial and subsequent recognition of items denominated in foreign currency.

Foreign currency transactions are transactions which are denominated in foreign currencies, rather than in the entity's functional currency. Such transactions arise when the entity:

- buys or sells goods or services whose price is denominated in a foreign currency;
- borrows or lends funds where the amounts payable or receivable are denominated in a foreign currency; and
- otherwise acquires or disposes of assets or incurs or settles liabilities denominated in a foreign currency.

Context example: Foreign currency translation

An entity trades in gold and has a US dollar functional currency, as most of its revenues and expenses are in US dollars. The entity is located in Frankfurt and as a result it also has significant transactions in euros. It has issued sterling-denominated share capital to its UK parent. Transactions with the parent are denominated in £. Which of the following transactions should management treat as foreign currency transactions?

- Euro transactions
- US dollar transactions
- Sterling transactions

The euro and sterling transactions are foreign currency transactions. The fact that the entity is located in Frankfurt does not preclude it from designating US dollars as its functional currency. All transactions which are not denominated in the entity's functional currency are foreign currency transactions.

3.1 Foreign currency transactions: initial recognition

An entity is required to recognise foreign currency transactions in its functional currency. The entity should achieve this by translating the foreign currency amount at the spot exchange rate between the functional currency and the foreign currency at the date on which the transaction took place.

The date of the transaction is the date on which the transaction first met the relevant recognition criteria.

Context example: Initial recognition

Albion Ltd is a UK manufacturing company with sterling as its functional currency. The company has ordered raw materials from a French supplier for €200,000. It recorded the transaction on 1 August 20X6, the date of the supplier's invoice. On that date the exchange rate was £1 = €1.72 and the amount recorded as purchase price is £116,279.

3.1.1 Average rate

Where an entity has a high volume of transactions in foreign currencies, translating each transaction may be an onerous task, so an average rate may be used. For example, a duty-free shop at Heathrow airport may receive a large amount of dollars and euros every day and may opt to translate each currency into sterling using an average weekly rate.

IAS 21 provides no further guidance on how an average rate should be determined, and therefore an entity should develop a method which is easily implemented with regard to limitations in its accounting systems. Application of an average monthly rate, based on actual daily rates, would seem a reasonable approach. Consistent application of the process for determining an appropriate average rate should be adopted each period.

However, as the average rate is an approximation of the rate of the day of the transaction, an average rate should not be adopted if exchange rates or underlying transactions fluctuate significantly (eg, due to seasonality), because in this case an average rate is not a good approximation.

Worked example: Use of average exchange rate

An entity, which has sterling as its functional currency, acquires a Ruritanian denominated bond on 1 January 20X1 for RU£1,000. The bond has five years to maturity and carries a variable market rate of interest which is currently 6%. Interest is accrued on a daily basis for a calendar year. Interest is paid on 31 January in the following calendar year (that is, interest for 20X1 will be paid on 31 January 20X2).

Management intends to hold the bond to maturity. The bond is therefore carried at amortised cost. The interest income and exchange differences are recognised in profit or loss. The exchange rate at the date of acquisition was RU£1 = £1.50.

At 31 December 20X1, the exchange rate was RU£1 = £2.00. The average rate for the period is RU£1
= £1.75 (based on average rates published by the Central Bank of Ruritania, which are daily weighted average rates).

Requirement

What rate should management use for the translation of interest income that accrues on a daily basis when there is a significant fluctuation in the exchange rate?

Solution

Management should use the daily weighted average exchange rate published by the Central Bank of Ruritania. Interest income accrues evenly through the period and the weighted average rate will produce the same result as a daily actual rate calculation.

The use of an unweighted average rate would not be appropriate because exchange rates fluctuate significantly.

Recognition of interest receivable:

DEBIT	Investment in debt instrument	£105 (RU£60 × 1.75)	
CREDIT	Interest income		£105

3.1.2 Multiple exchange rates

It may be the case that a country operates a two (or more) rate system, such as one for capital transactions and another for revenue items. Where more than one exchange rate exists, the rate to be applied is the one at which the transaction or balance would have been settled if settlement had taken place at the measurement date. If there is a temporary lack of published exchange rates between two currencies, the entity should apply the next available exchange rate published.

3.1.3 Suspension of rates

On certain occasions, developing countries experience economic problems that affect the convertibility of their currency. There is no exchange rate to be used in this case to translate foreign currency transactions. The standard requires companies to use the rate on the first subsequent date at which exchanges could be made.

3.2 Subsequent measurement

A foreign currency transaction may give rise to assets or liabilities that are denominated in a foreign currency. These assets and liabilities will need to be translated into the entity's functional currency at each reporting date. How they will be translated depends on whether the assets or liabilities are monetary or non-monetary items.

3.2.1 Monetary items

The essential feature of a monetary item, as the definition implies, is the right to receive (or an obligation to deliver) a fixed or determinable number of units of currency. Examples of monetary assets include the following:

- Cash and bank balances
- Trade receivables and payables
- Loan receivables and payables
- Foreign currency bonds held as available for sale
- Foreign currency bonds held to maturity
- Pensions and other employee benefits to be paid in cash
- Provisions that are to be settled in cash
- Cash dividends that are recognised as a liability
- A contract to receive (or deliver) a variable number of the entity's own equity instruments or a variable amount of assets in which the fair value to be received (or delivered) equals a fixed or determinable number of units of currency

Foreign currency **monetary items** outstanding at the reporting date **shall be translated** using the **closing rate**. The difference between this amount and the previous carrying amount in functional currency is an exchange gain or loss (covered in more detail in section 3.3).

3.2.2 Non-monetary items

A non-monetary item does not give the right to receive or create the obligation to deliver a fixed or determinable number of units of currency. Examples of non-monetary items include the following:

- Amounts prepaid for goods and services (eg, prepaid rent)
- Goodwill
- Intangible assets
- Inventories
- Property, plant and equipment
- Provisions to be settled by the delivery of a non-monetary asset
- Investments in equity instruments
- Equity investments in subsidiaries, associates or joint ventures

Non-monetary items carried at historical cost are translated using the **exchange rate at the date of the transaction when the asset arose** (historical rate). They are **not subsequently retranslated** in the individual financial statements of the entity. The foreign currency carrying amount is determined according to appropriate accounting standards (eg, IAS 2 for inventories, IAS 16 for property, plant and equipment measured at cost).

Non-monetary items carried at **fair value** are translated using the exchange rate at the date **when the fair value was determined**. The foreign currency fair value of a non-monetary asset is determined by the relevant standards (eg, IAS 16 for property, plant and equipment and IAS 40 for investment property).

Interactive question 1: Initial recognition

A UK company lends €10 million to its Portuguese supplier of Port wine to upgrade its production facilities. At the time of the loan, in July 20X5, the exchange rate was £1 = €2. The loan is repayable on 31 December 20X5. Initially the loan will be translated and recorded in the UK company's financial statements at £5 million. The amount that the company will ultimately receive will depend on the exchange rate on the date when the loan is repaid.

At 31 December 20X5, the exchange rate was £1 = €2.50.

Requirement

Calculate the exchange gain or loss.

See **Answer** at the end of this chapter.

3.2.3 Issues in the measurement of non-monetary assets

(a) Subsequent **depreciation** should be translated on the same basis as the asset to which it relates, so the rate at the date of acquisition for assets carried at cost and the rate at the last valuation date for assets carried at revalued amounts. Application of the depreciation method to the translated amount will achieve this.

(b) The carrying amount of inventories is the lower of cost and net realisable value in accordance with IAS 2, *Inventories*. The carrying amount in the functional currency is determined by comparing:

   (1) the cost, translated at the exchange rate at the date when that amount was determined; and

(2) the net realisable value, translated at the exchange rate at the date when that value was determined (eg, the closing rate at the reporting date).

Worked example: Translation of inventory acquired in a foreign currency

Entity J's functional currency is the pound sterling. Entity J acquired inventories for $300,000 on 1 July 20X5 when the exchange rate was $1.50: £1. At 31 December 20X5, its carrying amount is $300,000 and its net realisable value has risen to $340,000. The exchange rate at 31 December 20X5 is $1.80: £1.

Requirement

How should management translate the inventory acquired?

Solution

Expressed in dollars, the inventory value has gone up, its net realisable amount exceeding its carrying amount. In sterling, the carrying amount using the acquisition date rate is £200,000 ($300,000/1.5) and the net realisable amount using the closing rate is £189,000 ($340,000/1.8). Inventory is stated at the lower of cost and net realisable value in the functional currency and the carrying amount at 31 December 20X5 is £189,000.

Impairment testing of foreign currency non-monetary assets

Similarly in accordance with IAS 36, *Impairment of Assets*, the carrying amount of an asset for which there is an indication of impairment is the lower of:

- the carrying amount, translated at the exchange rate at the date when that amount was determined; and
- the recoverable amount, translated at the exchange rate at the date when that value was determined (eg, the closing rate at the reporting date).

The effect of this comparison may be that an impairment loss is recognised in the functional currency but would not be recognised in the foreign currency or vice versa.

Worked example: Translation of impaired non-monetary item

An entity whose functional currency is the pound sterling acquired on 30 September 20X4 a non- depreciable foreign currency asset costing $450,000. The exchange rate on 30 September 20X4 was
$1.50/£1 and the asset was recorded at the date of purchase at £300,000. There are indications that the non-current asset has been impaired during the year.

At 31 December 20X5, the reporting date, the asset's recoverable amount in foreign currency is estimated to be $400,000 when £1 = $1.25.

Requirement

How should the transaction be recorded?

Solution

Expressed in foreign currency, the asset has a carrying value of $450,000 and a recoverable amount of $400,000 and is therefore impaired.

However, when it is expressed in sterling, the asset is not impaired, because its recoverable amount exceeds its carrying amount. In sterling, the carrying amount, using the acquisition date rate, is £300,000 ($450,000/1.5) and the recoverable amount, using the closing rate, is £320,000 ($400,000/1.25). The depreciation of the foreign currency relative to pounds sterling has offset the fall in the value of the asset due to impairment, therefore no impairment charge is required.

3.2.4 Measurement of financial assets Initial measurement

Financial assets can be **monetary** or **non-monetary** and may be carried at **fair value** or **amortised cost**. Where a financial instrument is denominated in a foreign currency, it is initially recognised at fair value in the foreign currency and translated into the functional currency at spot rate. The fair value of the financial instrument is usually the same fair value of the consideration given in the case of an asset or received in the case of a liability.

Subsequent measurement

At each year end, the foreign currency amount of financial instruments carried at **amortised cost** is translated into the functional currency using either the closing rate (if it is a monetary item) or the historical rate (if it is a non-monetary item). Financial instruments carried at **fair value** are translated to the functional currency using the closing spot rate.

Recognition of exchange differences

The entire change in the carrying amount of a non-monetary investment in equity instruments including the effect of changes in foreign currency rates, is reported as other comprehensive income (OCI) at the reporting date.

A change in the carrying amount of monetary financial assets on subsequent measurements is analysed between the foreign exchange component and the fair value movement. The foreign exchange component is recognised in profit or loss and the fair value movement is recognised as other comprehensive income.

The entire change in the carrying amount of financial instruments measured at fair value through profit or loss, including the effect of changes in foreign currency rates, is recognised in profit or loss.

Worked example: Translation of non-monetary asset

On 1 January 20X5 an entity whose functional currency is the pound sterling purchased a US dollar denominated equity instrument at its fair value of $500,000. (The entity has made an irrevocable election under IFRS 9 to record changes in the value of investments in equity instruments in other comprehensive income.) The exchange rate at acquisition date was $1.90/£. The exchange rates and the fair value of the instrument denominated in US dollars at different reporting dates are given below.

		Equity instrument value
	$/£1	**$**
31 December 20X5	1.80	480,000
31 December 20X6	1.60	450,000

Requirement

What is the fair value of the asset at 1 January 20X5, 31 December 20X5 and 31 December 20X6 in pounds sterling, and how will the changes in fair value be accounted for?

Solution

The asset is an investment in equity instruments, therefore a non-monetary financial asset. All exchange differences are reported in OCI.

	Exchange rate $/£1	Equity instrument value ($)	Equity instrument value (£)	Recognised in the current period *	Cumulative gains or losses *
1 January 20X5	1.9	500,000	263,158		
31 December 20X5	1.8	480,000	266,667	3,509	3,509
31 December 20X6	1.6	450,000	281,250	14,583	18,092

* Change in fair value recognised as other comprehensive income

3.3 Recognition of exchange differences

Exchange differences arise in the following circumstances:

- On retranslation of a monetary item at the year end
- When a monetary item is settled in cash (eg, a foreign currency payable is paid)
- Where there is an impairment, revaluation or other fair value change in a non-monetary item

3.3.1 Retranslation of monetary items

Where a monetary item arising from a foreign currency transaction remains outstanding at the reporting date, an exchange difference arises, being the difference between:

- Initially recording the item at the rate ruling at the date of the transaction (or when it was translated at a previous reporting date)
- The subsequent retranslation of the monetary item to the rate ruling at the reporting date

Such **exchange differences** should be reported as part of the **profit or loss for the year**.

3.3.2 Settlement of monetary items

Exchange differences arising on the settlement of monetary items (receivables, payables, loans, cash in a foreign currency) should be **recognised in profit or loss** in the period in which they arise.

There are two situations to consider.

(a) The transaction is **settled in the same period** as that in which it occurred: all the exchange difference is recognised in that period.

(b) The transaction is **settled in a subsequent accounting period**: an exchange difference is recognised in each intervening period up to the period of settlement, determined by the change in exchange rates during that period (as per section 3.3.1). A further exchange difference is recognised in the period of settlement.

Worked example: Recognition of exchange differences on monetary item settled in the same period

White Cliffs Co, whose year end is 31 December, buys some goods from Rinka SA of France on 30 September. The invoice value is €40,000 and is due for settlement on 30 November. The exchange rate moved as follows.

	€/£1
30 September	1.60
30 November	1.80

Requirement

State the accounting entries in the books of White Cliffs Co.

Solution

The purchase will be recorded in the books of White Cliffs Co using the rate of exchange ruling on 30 September.

DEBIT	Purchases	£25,000	
CREDIT	Trade payables		£25,000

Being the £ cost of goods purchased for €40,000 (€40,000 ÷ €1.60/£1)

On 30 November, White Cliffs must pay €40,000. This will cost €40,000 ÷ €1.80/£1 = £22,222 and the company has therefore made an exchange gain of £25,000 – £22,222 = £2,778.

DEBIT	Trade payables	£25,000	
CREDIT	Exchange gains: profit or loss		£2,778
CREDIT	Cash		£22,222

Worked example: Recognition of exchange differences on monetary item settled in a subsequent accounting period

White Cliffs Co, whose year end is 31 December, buys some goods from Rinka SA of France on 30 September. The invoice value is €40,000 and is due for settlement in equal instalments on 30 November and 31 January. The exchange rate moved as follows.

	€/£1
30 September	1.60
30 November	1.80
31 December	1.90
31 January	1.85

Requirement

State the accounting entries in the books of White Cliffs Co.

Solution

The purchase will be recorded in the books of White Cliffs Co using the rate of exchange ruling on 30 September.

DEBIT	Purchases	£25,000	
CREDIT	Trade payables		£25,000

Being the £ sterling cost of goods purchased for €40,000 (€40,000 ÷ €1.60/£1)

On 30 November, White Cliffs must pay €20,000 to settle half the payable (£12,500). This will cost €20,000 ÷ €1.80/£1 = £11,111 and the company has therefore made an exchange gain of £12,500 – £11,111 = £1,389.

DEBIT	Trade payables	£12,500	
CREDIT	Exchange gains: profit or loss		£1,389
CREDIT	Cash		£11,111

On 31 December, the reporting date, the outstanding liability of £12,500 will be recalculated

using the rate applicable at that date: €20,000 ÷ €1.90/£1 = £10,526. A further exchange gain of £1,974 (£12,500 – £10,526) has been made and will be recorded as follows.

DEBIT	Trade payables	£1,974	
CREDIT	Exchange gains: profit or loss		£1,974

The total exchange gain of £3,363 will be included in the operating profit for the year ending 31 December.

On 31 January, White Cliffs must pay the second instalment of €20,000 to settle the remaining liability of £10,526. This will cost the company £10,811 (€20,000 ÷ €1.85/£1).

DEBIT	Trade payables	£10,526	
DEBIT	Exchange losses: Profit or loss	£285	
CREDIT	Cash		£10,811

3.3.3 Exceptions to the general rule

As set out above, exchange differences should normally be recognised as part of profit or loss for the period. This treatment is required in an entity's own financial statements even in respect of differences on certain monetary amounts receivable from, or payable to, a foreign operation. If the settlement of these amounts is neither 'planned nor likely to occur', they are in effect part of the entity's net investment in the foreign operation.

In the following cases the exchange differences on monetary items are not reported in profit or loss because hedge accounting provisions under IFRS 9 (or IAS 39 if the entity still applies this) overrule the regulations of IAS 21.

(a) A monetary item designated as a hedge of a net investment in consolidated financial statements. In this case any exchange difference that forms part of the gain or loss on the hedging instrument is recognised as other comprehensive income.

(b) A monetary item designated as a hedging instrument in a cash flow hedge. In this case any exchange difference that forms part of the gain or loss on the hedging instrument is recognised as other comprehensive income.

(c) Exchange differences arising in respect of monetary items which are part of the net investment are recognised in profit or loss in the individual financial statements of the entity or foreign operation as appropriate. However, in the consolidated statement of financial position the exchange differences are recognised in equity. This exemption arises only on consolidation and is dealt with in the section on consolidation.

3.3.4 Non-monetary items

Where a non-monetary item (eg, inventory or a non-current asset) is recognised at historical cost (and there is no impairment) then it is translated into the functional currency **at the exchange rate on the date of the transaction**. It is **not** then retranslated at subsequent reporting dates in the individual financial statements of the entity, and therefore no exchange differences arise.

However, exchange differences do arise on non-monetary items when there has been a change in their underlying value (eg, fair value changes, revaluations or impairments). These are recognised as follows.

(a) When a gain or loss on a non-monetary item is recognised **as other comprehensive income** (for example, where property denominated in a foreign currency is revalued) any **related exchange differences** should also be **recognised as other comprehensive income**.

(b) When a gain or loss (eg, fair value change) on a non-monetary item is recognised in profit or loss, any exchange component of that gain or loss is also recognised in profit or loss.

Several examples are given below to highlight the issues that arise in the recognition of exchange differences on non-monetary items.

Interactive question 2: Rumble plc

Rumble plc is a retailer of fine furniture. On 19 October 20X5 Rumble purchased 100 identical antique tables from a US supplier for a total of $3,600,000. Rumble has a year end of 31 December 20X5 and uses sterling as its functional currency.

Exchange rates are as follows. 19 October 20X5: £1 = $1.80 15 December 20X5: £1 = $1.90

20 December 20X5: £1 = $1.95 31 December 20X5: £1 = $2.00

Average rate for 20X5: £1 = $1.60 3 February 20X6: £1 = $2.40 **Requirement**

Determine, according to IAS 21, *The Effects of Changes in Foreign Exchange Rates,* the impact of the above transaction on the profits of Rumble for the year ended 31 December 20X5 and on the statement of financial position at that date under each of the following alternative assumptions.

Assumption 1: All the tables were sold on 20 December 20X5 and were paid for by Rumble on 15 December 20X5.

Assumption 2: All the tables were sold on 3 February 20X6 and were paid for by Rumble on 15 December 20X5.

Assumption 3: All the tables were sold on 15 December 20X5 and were paid for by Rumble on 3 February 20X6.

Assumption 4: 75 of the tables were sold on 15 December 20X5 with the remaining 25 tables being sold on 3 February 20X6. All the tables were paid for by Rumble on 3 February 20X6.

See **Answer** at the end of this chapter.

Worked example: Translation of investment property

An entity whose functional currency is the pound sterling holds an investment property in Singapore. The investment property is carried at fair value in accordance with IAS 40. The investment property had a fair value at 31 December 20X2 of S$10,000,000 and S$12,000,000 at 31 December 20X3. The exchange rates were as follows.

31 December 20X2: £1: S$1.65

31 December 20X3: £1: S$1.63

Requirement

How should management recognise the change in the value of this investment property?

Solution

Management should recognise the investment property at £6,060,606 and £7,361,963 at 31 December 20X2 and 31 December 20X3 respectively.

The change in value is calculated as:

31 December 20X2 (S$10,000,000/1.65)	£6,060,606
31 December 20X3 (S$12,000,000/1.63)	£7,361,963
Increase in fair value	£1,301,357

The increase in fair value of £1,301,357 should be recognised in profit or loss as a gain on investment property.

The investment property is a non-monetary asset. The movement in value attributable to movement in exchange rates £74,363 ($10,000,000/1.65) – ($10,000,000/1.63) should not be recognised separately because the asset is non-monetary.

Context example: Translation of property – revaluations

A UK-based entity with a sterling functional currency has a property located in Spain which was acquired at a cost of €6 million when the exchange rate was £1 = €1.50. At the reporting date the property was revalued to €8 million. The exchange rate on the reporting date was £1 = €1.60.

Ignoring depreciation, the amount that would be recognised as other comprehensive income is:

	€	€/£	£
Value at reporting date	8,000,000	1.6	5,000,000
Value at acquisition	6,000,000	1.5	4,000,000
Revaluation surplus recognised in equity			1,000,000

The revaluation surplus may be analysed as follows.

	€	€/£	£	£
Change in fair value	2,000,000	1.6		1,250,000
Exchange component of change				
	€	€/£	£	£
	6,000,000	1.6	3,750,000	
	6,000,000	1.5	4,000,000	
				(250,000)
Revaluation surplus recognised as other comprehensive income				1,000,000

Professional skills focus: Structuring problems and solutions

When presented with a problem like this it is important to break it down into its component parts. It is clear that the revaluation surplus is made up of two components – the change in fair value and the exchange movement.

Interactive question 3: Translation of land – revaluations

Entity A, incorporated in Muritania (local currency Muritania lira), is the treasury department of Entity B which has British pounds as its functional currency. The functional currency of Entity A is also the British pound, as it is not autonomous from its parent. Entity A's management follows the revaluation model in IAS 16 and measures its land and buildings at revalued amounts (based on periodic valuations as necessary but not less frequent than every three years). A piece of land was acquired on 1 June 20X4 and is not depreciated. It has been revalued on 31 December 20X5 and 31 December 20X6 respectively as follows.

	Muritania lira	**Date**	**Exchange rate**	**£**
Cost at acquisition	200,000	Bought on 1 June 20X4	M lira 1 = £1.30	260,000
Fair value	250,000	As at 31 December 20X5	M lira 1 = £1.00	250,000
Fair value	260,000	As at 31 December 20X6	M lira 1 = £1.20	312,000

Requirement

How should management translate the land held at fair value in accordance with IAS 16? See

Answer at the end of this chapter.

Worked example: Impairment in non-monetary item

A UK-based entity with a sterling functional currency has a property located in Spain which was acquired at a cost of €6 million when the exchange rate was £1 = €1.50. The property is carried at cost. At the reporting date the recoverable amount of the property as a result of an impairment review amounted to €5 million. The exchange rate at the reporting date was £1 = €1.60.

Requirement

Ignoring depreciation, determine the amount of the impairment loss that would be reported in profit or loss as a result of the impairment.

Solution **Impairment loss**

	€	**€/£**	**£**	**£**
Carrying amount at reporting date	5,000,000	1.6	3,125,000	

	€	**€/£**	**£**	**£**
Historical cost	6,000,000	1.5	4,000,000	
Impairment loss recognised in profit or loss			(875,000)	

The impairment loss may be analysed as follows.

	€	**€/£**	**£**	**£**
Change in value due to impairment	1,000,000	1.6		(625,000)
Exchange component of change	6,000,000	1.6	3,750,000	
	6,000,000	1.5	4,000,000	
				(250,000)
Impairment loss recognised in profit or loss				(875,000)

Worked example: Translation of financial instruments

Entity A, whose functional currency is the pound sterling, acquired on 30 September 20X4 two classes of dollar-denominated financial instruments. (Entity A's accounting year end is 31 December.)

(1) Investments in listed equity instruments for $10 million

(2) Investments in non-listed equity instruments for $10 million

At 31 December, management believe that the cost of the unlisted investments is still a reasonable approximation of their fair value. The fair value of the listed investments has increased to $14.4 million. An irrevocable election had been made under IFRS 9 to record changes in the value of investments in equity instruments in other comprehensive income.

Requirement

How should the relevant requirements of IFRS 9 and IAS 32 affect the translation of these financial instruments into the functional currency at 31 December 20X4?

Exchange rates

30 September 20X4	$1: £1
31 December 20X4	$1.20: £1

Solution

Management should recognise the financial instruments on 31 December 20X4 as follows.

(1) Listed equity instruments of £12 million. The listed shares are measured at fair value on 31 December 20X4, of $14.4 million and translated using the spot rate at the date of valuation, which is $1.20: £1. The gain of £2 million ($14.4m/1.2 – $10m/1.0) should be recorded as other comprehensive income.

(2) Non-listed equity instruments of £10 million. As the shares are recorded at their cost of $10 million, the foreign currency value should be translated to pounds sterling using the spot rate at the date of the transaction, which was $1: £1.

Context example: Translation of a branch into the functional currency

An entity based in the UK with the pound sterling as its functional currency operates a branch in Portugal where the functional currency is the euro. As the branch is an extension of the entity, the functional currency of the branch is also the pound sterling, but as a matter of convenience the branch records a number of transactions in euros. Assume that the €:£ exchange rates have been as follows.

1 January 20X3	€2.50: £1
1 January 20X4	€2.40: £1
30 June 20X5	€2.10: £1
30 September 20X5	€2.00: £1
31 December 20X5	€2.20: £1

Details of the branch balances at 31 December 20X5 requiring translation and the basis for calculating their sterling equivalents are as follows. The branch made all its sales on 30 September 20X5, and half of these were outstanding as trade receivables at the year end. All purchases were made on 30 June 20X5, and half of these are unpaid at 31 December 20X5.

Item	Basis	Balance €	Rate	£
Plant – acquired on 1 January 20X3				
Cost	Historical rate	50,000	€2.50: £1	20,000
Accumulated depreciation	Historical rate	(30,000)	€2.50: £1	(12,000)
Plant – acquired on 1 January 20X4		20,000		8,000
Cost	Historical rate	30,000	€2.40: £1	12,500
Accumulated depreciation	Historical rate	(12,000)	€2.40: £1	(5,000)
		18,000		7,500
Trade receivables	Closing rate	50,600	€2.20: £1	23,000
Trade payables	Closing rate	25,200	€2.20: £1	11,455
Revenue	Actual rate	101,200	€2.00: £1	50,600
Purchases	Actual rate	50,400	€2.10: £1	24,000
Depreciation charge for year				
1 January 20X3 plant	Historical rate	10,000	€2.50: £1	4,000
1 January 20X4 plant	Historical rate	6,000	€2.40: £1	2,500

Note that both the accumulated depreciation and the charge for the year are translated at the rate ruling when the relevant plant was acquired. Revenue and purchases are translated at the rate ruling when the transaction occurred, but the receivables and payables relating to them (which will have been initially recognised at those rates) are monetary items which are retranslated at closing rate at the end of the year.

4 Foreign currency translation of financial statements

Section overview

This section presents the rules for the translation of financial statements from the functional currency to the presentation currency.

We have discussed in the previous section the requirements of IAS 21 for the translation of foreign currency transactions. In this section we shall discuss the IAS 21 translation requirements when foreign activities are undertaken through foreign operations whose financial statements are based on a different functional currency than that of the parent company. More specifically in this section we shall discuss the appropriate exchange rate that should be used for the translation of the financial statements of the foreign operation into the reporting entity's presentation currency.

Although an entity is required to translate foreign currency items and transactions into its functional currency, it does not have to present its financial statements in this currency. Instead, IAS 21 permits an entity a completely free choice over the currency in which it presents its financial statements.

Where the chosen currency, the entity's presentation currency, is not the entity's functional currency, this fact should be disclosed in the financial statements, along with an explanation of why a different presentation currency has been applied.

The financial statements of a foreign operation operating in a hyperinflationary economy must be adjusted under IAS 29 before they are translated into the parent's reporting currency and then consolidated. When the economy **ceases to be hyperinflationary**, and the foreign operation ceases to apply IAS 29, the amounts restated to the price level at the date the entity ceased to restate its financial statements should be used as the historical costs for translation purposes.

4.1 Translation to the presentation currency when the functional currency is a non- hyperinflationary currency

The approach adopted for the translation into a presentation currency is also used for the preparation of consolidated financial statements where a parent has a foreign subsidiary. The process is set out below.

The following procedures should be followed to translate an entity's financial statements from its functional currency into a presentation currency.

(a) Translate all assets and liabilities (both monetary and non-monetary) in the current statement of financial position using the **closing rate** at the reporting date.

(b) Translate income and expenditure in the current statement of profit or loss and other comprehensive income using the exchange rates ruling at the transaction dates. An approximation to actual rate is normally used, being the **average rate**.

(c) Report the **exchange differences** which arise on translation as **other comprehensive income**; and where a foreign subsidiary is not wholly owned, allocate the relevant portion of the exchange differences to the non-controlling interest.

Note that the comparative figures are the presentation currency amounts as presented the previous year.

4.1.1 Translation of equity

No guidance is provided as to how amounts in equity should be translated. Using the closing rate would be consistent with the approach to the translation of assets and liabilities. Translation at historical rates may seem more appropriate, given the one-off, capital nature of such items such as share capital. As IAS 21 is not explicit in this respect, either approach may be adopted, although an entity should follow a consistent policy between periods.

4.2 Exchange differences

The exchange differences comprise:

(a) Differences arising from the translation of the statement of profit or loss and other comprehensive income at exchange rates at the transaction dates or at average rates and the translation of assets and liabilities at the closing rate.

(b) Differences arising on the opening net assets' retranslation at a closing rate that differs from the previous closing rate.

Resulting exchange differences are **reported as other comprehensive income** and classified as a separate component of equity, because such amounts have not resulted from exchange risks to which the entity is exposed, but purely through changing the currency in which the financial statements are presented. To report such exchange differences in profit or loss would distort the results from the trading operations, as shown in the functional currency financial statements, since these differences are unrelated to the foreign operation's trading performance or financial operation.

Worked example: Translation to presentation currency

XYZ, a UK-based company with sterling as its functional currency, has created a new subsidiary in the US on 1 January 20X5 with a share capital of US$55,000 subscribed in cash. The amounts in its 20X5 US dollar functional currency financial statements are shown below.

	US$
Statement of profit or loss	
Revenue	500,000
Costs	(200,000)
Profit	300,000
There was no other comprehensive income.	
Statement of financial position	
Initial share capital	55,000
Retained earnings (as above)	300,000
Equity = net assets	355,000

The entity owns no non-current assets (so there are no assets or depreciation charges to be translated at the rate ruling when the asset was acquired) and all transactions took place on 30 June (so that a single rate can be used for the statement of profit or loss transactions, rather than the various rates ruling when the transactions took place).

Assume that the following exchange rates are relevant. 1 January 20X5: £1 = US$2.75

30 June 20X5: £1 = US$2.50

31 December 20X5: £1 = US$2

The entity translates share capital at the rate ruling when the capital was raised.

Requirement

Translate the financial statements of the subsidiary into the pound sterling presentation currency.

Solution

The statement of profit or loss is translated using the actual rate on the transaction date.

Statement of profit or loss and other comprehensive income

	US$	Rate	£
Revenue	500,000	Actual	200,000
Costs	(200,000)	Actual	(80,000)
Profit	300,000		120,000
Other comprehensive income:			
Exchange gain on retranslation			37,500
Total comprehensive income			157,500

The net assets of the subsidiary are translated using the closing rate and the initial share capital using the opening rate. The statement of financial position is shown below.

Statement of financial position

	US$	Rate	£
Initial share capital	55,000	Opening	20,000
Retained earnings (as above)	300,000	Actual	120,000
Exchange differences			37,500
Equity = net assets	355,000	Closing	177,500

The exchange gain arising on consolidation has two components:

(1) An exchange gain arising on retranslating the opening net assets from the opening rate to the closing rate

	Rate	£
Opening net assets = initial share capital (US$55,000)	Closing	27,500
	Opening	20,000
		7,500

b

	Rate	£
Retained earnings (US$300,000)	Closing rate	150,000
	Actual rate	(120,000)
	-	30,000
Total exchange differences		37,500

The inclusion of the exchange gain or loss makes the accounting equation balance since:

Closing net assets (translated at closing rate)	=	Opening net assets (translated at opening rate + exchange difference)	+	Profit (translated at the actual rate + exchange difference)

The calculation of the exchange difference is discussed in more detail in section 5.3.

4.3 Translation when the functional currency is a hyperinflationary currency

Where an entity's functional currency is that of a hyperinflationary economy and it uses a presentation currency which is different from its functional currency, all the functional currency amounts restated under IAS 29, *Financial Reporting in Hyperinflationary Economies* should be translated at the closing rate at the current reporting date. The one exception is that where the presentation currency used is that of a non-hyperinflationary economy, the comparative amounts should be as they were presented in the previous period. There is no IAS 29 adjustment for the effect of hyperinflation in the current period.

Interactive question 4: Translation of a foreign operation

A UK-based company, Petra Ltd, set up a foreign subsidiary, Hellenic Marble, in Greece on 30 June 20X6. Petra Ltd subscribed €24,000 for share capital when the exchange rate was €2 = £1. The subsidiary borrowed €72,000 and bought a non-monetary asset for €96,000. Petra Ltd prepared its accounts on 31 December 20X6 and by that time the exchange rate had moved to €3 = £1. No activity was undertaken by the subsidiary during the period and it had no profits or losses.

Requirement

Account for the above transactions.

See **Answer** at the end of this chapter.

5 Foreign currency and consolidation

Section overview

This section deals with the issues arising from consolidating financial statements and, in particular, the treatment of exchange differences and goodwill.

5.1 Translation of a foreign operation

A reporting entity with foreign operations needs to translate the financial statements of those operations into its own reporting currency before consolidation or inclusion through the equity method. The method of translation described in section 4 above should be applied to the financial statements of a foreign operation. The treatment is summarised here.

(a) **Statement of profit or loss and other comprehensive income**: translate using actual rates. An average for a period may be used, but not where there is significant fluctuation and the average is therefore unreliable.

(b) **Statement of financial position**: translate all assets and liabilities (both monetary and non-monetary) using closing rates.

(c) **Exchange differences** are reported as other comprehensive income.

5.2 Consolidation

The incorporation of the results and financial position of a foreign operation with those of the reporting entity follows normal consolidation procedures, such as the elimination of intra-group balances and intra-group transactions of a subsidiary. However, an intra-group monetary asset (or liability) whether short term or long term cannot be eliminated against the corresponding intra- group liability (or asset) without showing the results of currency fluctuations in the consolidated financial statements. This is because a monetary item represents a commitment to convert one currency into another and exposes the reporting entity to a gain or loss through currency fluctuations. Accordingly, in the consolidated financial statements of the reporting entity, such an exchange difference:

- continues to be recognised in profit or loss; or
- is classified as equity until the disposal of the foreign operations, if it is a monetary asset forming part of the net investment in a foreign operation.

Worked example: Consolidated financial statements

The abridged statements of financial position and profit or loss of Darius Co and its foreign subsidiary, Xerxes Inc, appear below.

Draft statement of financial position as at 31 December 20X9

	Darius Co		Xerxes Inc	
	£	£	€	€
Assets				
Non-current assets				
Plant at cost	600		500	
Depreciation	(250)		(200)	
		350		300
Investment in Xerxes				
100 shares @ £0.25 per share		25		
		375		300
Current assets				
Inventories	225		200	
Receivables	150		100	
		375		300
		750		600
Equity and liabilities				
Equity				
Ordinary £1/€1 shares	300		100	
Retained earnings	300		280	
		600		380
Long-term loans		50		110
Current liabilities		100		110
		750		600

Statements of profit or loss for the year ended 31 December 20X9

	Darius Co	Xerxes Inc
	£	€
Profit before tax	200	160
Tax	(100)	(80)
Profit after tax, retained	100	80

The following further information is given.

(1) Darius Co has had its interest in Xerxes Inc since the incorporation of the company.

(2) Depreciation is 8% per annum on cost.

(3) The carrying amount of equity of Xerxes at 31 December 20X8 was €300.

(4) There have been no loan repayments or movements in non-current assets during the year. The opening inventory of Xerxes Inc was €120. Assume that inventory turnover times are very short.

(5) Exchange rates:

(a) €4 to £1 when Xerxes Inc was incorporated

(b) €2.50 to £1 when Xerxes Inc acquired its long-term assets

(c) €2 to £1 on 31 December 20X8

(d) €1.60 to £1 average rate of exchange year ending 31 December 20X9

(e) €1 to £1 on 31 December 20X9

Requirements

1 Prepare the summarised consolidated statement of profit or loss and statement of financial position of Darius Co using the £ as the presentation currency.

2 Calculate the exchange difference and prepare a separate consolidated statement of profit or loss and other comprehensive income for the year.

Solution

1 **Statement of profit or loss of Xerxes for the year ended 31 December 20X9** translated using the average rate (€1.60 = £1)

	£
Profit before tax	100
Tax	(50)
Profit after tax, retained	50

Consolidated statement of profit or loss for the year ended 31 December 20X9

		£
Profit before tax	£(200 + 100)	300
Tax	£(100 + 50)	(150)
Profit after tax, retained	£(100 + 50)	150

The statement of financial position of Xerxes Inc at 31 December 20X9, other than share capital and reserves, should be translated at the closing rate of €1 = £1.

Summarised statement of financial position of Xerxes in £ at 31 December 20X9

	£	£
Non-current assets (carrying amount)		300
Current assets		
Inventories	200	
Receivables	100	
		300
		600
Non-current liabilities		110
Current liabilities		110
Equity = 600 – 110 – 110 = 380		380
		600

Since Darius Co acquired the whole of the issued share capital on incorporation, the post-acquisition reserves including exchange differences will be the value of shareholders' funds arrived at above, less the original cost to Darius Co of £25 (ie, €100 at the historical exchange rate of £1: €4). Post-acquisition increase in equity = £380 – £25 = £355.

Summarised consolidated statement of financial position as at 31 December 20X9

		£	£
Assets			
Non-current assets (NBV)	£(350 + 300)		650
Current assets			
Inventories	£(225 + 200)	425	
Receivables	£(150 + 100)	250	
			675
			1,325

Equity and liabilities

		£
Equity		
Ordinary £1 shares (Darius only)		300
Retained earnings	£(300 + 355)	655
		955
Non-current liabilities: loans	£(50 + 110)	160
Current liabilities	£(100 + 110)	210
		1,325

Note: It is quite unnecessary to know the amount of the exchange differences when preparing the consolidated statement of financial position.

2 **Calculation of exchange differences**

	£
Xerxes's equity interest at 31 December 20X9	380
Equity interest at 1 January 20X9 (€300/2)	(150)
	230
Less retained profit	(50)
Exchange gain	180

Consolidated statement of profit or loss and other comprehensive income for the year ended 31 December 20X9

	£
Profit after tax	150
Exchange difference on translation of foreign operations	180
Total comprehensive income for the year	330

Note: The post-acquisition reserves of Xerxes Inc at the beginning of the year must have been £150 – £25 = £125 and the post-acquisition reserves of Darius Co must have been £300 – £100 = £200. The consolidated post-acquisition reserves must therefore have been £325.

Professional skills focus: Assimilating and using information

While the information regarding exchange rates must be assimilated and used, it is important not to lose sight of the fact that foreign currency consolidation questions have standard group aspects that should not be rushed or overlooked.

5.3 Analysis of exchange differences

The exchange differences in the above exercise could be reconciled by splitting them into their component parts.

The total exchange difference arises from the following:

- Translating **income/expense items** using an average rate, whereas **assets/liabilities** are translated at the closing rate
- Translating the **opening net investment** (opening net assets) in the foreign entity at a closing rate different from the closing rate at which it was previously reported

Using the opening statement of financial position and translating at opening rate of €2 = £1 and the closing rate of €1 = £1 will produce the exchange differences as follows.

	€2 = £1	€1 = £1	Exchange difference
	£	£	£
Non-current assets at carrying amount	170	340	170
Inventories	60	120	60
Net current monetary liabilities	(25)	(50)	(25)
	205	410	205
Equity	150	300	150
Loans	55	110	55
	205	410	205

Translating the statement of profit or loss using average rate €1.60 = £1 and the closing rate €1 = £1 gives the following results.

	€1.60 = £1	€1 = £1	Exchange difference
	£	£	£
Profit before tax, depreciation and increase in inventory values	75	120	45
Increase in inventory values	50	80	30
	125	200	75
Depreciation	(25)	(40)	(15)
	100	160	60
Tax	(50)	(80)	(30)
Profit after tax, retained	50	80	30

The overall position is then:

	£
Gain on non-current assets (£170 – depreciation £15)	155
Loss on loan	(55)
	£
Gain on inventories (£60 + £30)	90
Loss on net monetary current assets/liabilities (all other differences) (£45 – £30 – £25)	(10)
Net exchange gain: as above	180

This can be simplified as:

	£	£
Opening net assets of €300: at opening rate (€2: £1)	150	
at closing rate (€1: £1)	300	
		150 gain
Retained profits of €80: at average rate (€1.60: £1)	50	
at closing rate (€1: £1)	80	
		30 gain
		180 gain

This exchange difference is recorded as other comprehensive income.

(a) The group share is included within total comprehensive income attributable to the shareholders of the parent company (and so included in the group reserves calculation).

(b) The non-controlling interest share is included within total comprehensive income attributable to the non-controlling interest.

5.4 Goodwill and fair value adjustments

Goodwill arising under IFRS 3, *Business Combinations* from the acquisition of a foreign operation should initially be calculated in the functional currency of the subsidiary and then be treated as an asset of the foreign operation and translated at the **closing rate** each year. The exchange difference arising is recorded as other comprehensive income in the consolidated accounts and accumulated in group equity.

The carrying amount of goodwill in the presentation currency is therefore as affected by changes in exchange rates as any other non-current asset. This may result in goodwill being allocated to an entity for the purpose of foreign currency translation at a different level from that used for impairment testing, which should continue to be determined based on IAS 36.

Adjustments made to the fair values of assets and liabilities of a foreign operation under IFRS 3 should be treated in the same way as goodwill. The adjustments are recognised in the carrying amounts of the assets and liabilities of the foreign operation in its functional currency. The adjusted carrying amounts are then translated at the closing rate.

Context example: Goodwill adjustment

On 31 December 20X4, ABC acquired 80% of DEF for £10 million when the carrying amount of DEF's identifiable net assets was €8 million. The carrying amounts were the same as fair value except for land which is not subject to depreciation and had a fair value of €1 million higher than carrying amount. The carrying amount in DEF's financial statements was not altered.

The €/£ exchange rate was €2.40/£ at 31 December 20X4, and €2.50/£ at 31 December 20X5. The non-controlling interest is measured using the proportion of net assets method.

The goodwill arising on consolidation was:

	€'000
Consideration transferred	24,000
Non-controlling interest 20% × (€8m + €1m)	1,800
	25,800
Net assets of acquiree €8m + €1m)	(9,000)
Goodwill	16,800

The goodwill arising on acquisition is therefore €16.8m/2.4 = £7m. The fair value adjustment in sterling amounted to €1m/2.4 = £416,667.

At 31 December 20X5, the goodwill is restated to £6.72 million (€16.8m/2.5) and the fair value adjustment in sterling terms was £400,000 (€1m/2.5).

The requirement in an entity's own financial statements to recognise in profit or loss all exchange differences in respect of monetary items which are part of an entity's net investment in a foreign operation was dealt with earlier.

On consolidation, however, the differences should be recognised as other comprehensive income and recorded in a separate component of equity. This treatment is required because exchange differences arising from the translation of the operations' net assets will move in the opposite way. If there is an exchange loss on the net investment, there will be an exchange gain on the net assets, and vice versa. The two movements should be netted off, rather than one being recognised in profit or loss and the other as other comprehensive income.

5.5 Net investment in foreign operation

A parent company may have a monetary item that is payable to or receivable from a foreign operation, ie, an intragroup loan outstanding. In order to qualify as a net investment in a foreign operation, settlement must neither be planned, nor expected to occur in the foreseeable future. Such monetary items would include long-term loans or receivables, but not trade payables or receivables. When a monetary item is part of the net investment in a foreign operation (ie, there is an intra-group loan outstanding) then the following rules apply on consolidation.

(a) If the monetary item is denominated in the functional currency of the parent entity, the exchange difference will be recognised in the profit or loss of the foreign subsidiary.

(b) If the monetary item is denominated in the functional currency of the subsidiary, exchange differences will be recognised in the profit or loss of the parent entity.

(c) When the monetary item is denominated in the functional currency of either entity, on consolidation, the exchange difference will be removed from the consolidated profit or loss and it will be recognised as other comprehensive income and recorded in equity in the combined statement of financial position.

(d) If, however, the monetary item is denominated in a third currency which is different from either entity's functional currency, then the translation difference should be recognised as part of profit or loss. For example, the parent may have a functional currency of US dollars, the foreign operation a functional currency of euros, and the loan made by the foreign operation may have been denominated in UK sterling. In this scenario, the exchange difference results in a cash flow difference and should be recognised as part of the results of the group.

(e) A separate foreign currency reserve reported as part of equity may have a positive or negative carrying amount at the reporting date. Negative reserves are permitted under IFRS® Standards.

(f) If the foreign operation is subsequently disposed of, the cumulative exchange differences previously reported as other comprehensive income and recognised in equity should be reclassified and so included in the profit or loss on disposal recognised in the statement of profit or loss.

Context example: Exchange changes

Some years ago ABC, whose functional currency is pounds sterling, made a long-term loan of £100,000 to its wholly owned subsidiary, DEF, whose functional currency is the euro. At 31 December 20X4, the exchange rate was £1 = €3, and at 31 December 20X5 was £1 = €2.50. No settlement of the loan is planned or likely to occur in the foreseeable future.

At 31 December 20X4, €300,000 (£100,000 × 3) was a payable in DEF's financial statements. ABC carried the receivable at £100,000, so on consolidation the two amounts cancelled out.

At 31 December 20X5, only €250,000 (£100,000 × 2.5) was a payable in DEF's financial statements, so in 20X5 DEF made an exchange gain of €50,000 in its own financial statements. On consolidation DEF's payable still cancels out against ABC's £100,000 receivable.

However, on consolidation, the sterling equivalent of DEF's exchange gain (€50,000/2.5 = £20,000) is eliminated from consolidated profit or loss and shown as part of total exchange differences reported as other comprehensive income.

5.6 Consolidation when subsidiaries have different reporting dates

Where the reporting date of entities included in the consolidated financial statements of the group are different, and in accordance with IFRS 10 an earlier set of financial statements is used for consolidation purposes, there is an issue as to which exchange rate should be used; the one at the date of the earlier set of financial statements, or the one at the reporting date of the consolidated financial statements.

Under IAS 21, for all subsidiaries, associates and joint ventures which are consolidated or equity accounted, the relevant exchange rate is that ruling at the date to which the foreign operation's financial statements were prepared. This reflects the fact that the foreign operation's results are prepared to its reporting date and exchange differences should be calculated in a consistent way. However, IAS 21 goes on to state that, where the exchange rate has significantly changed in the period between the foreign operation's year end and that of the group, an adjustment should be made. This is consistent with the approach in IFRS 10 for significant events that have happened in this intervening period. The same approach is used in applying the equity method to associates and joint ventures in accordance with IAS 28, *Investments in Associates and Joint Ventures*.

5.7 Intra-group trading transactions

Where normal trading transactions take place between group companies located in different countries, the transactions give rise to monetary assets or liabilities that may either have been settled during the year or remain unsettled at the reporting date.

Context example: Intra-group trading

A UK parent company has a wholly owned subsidiary in the US. During the year ended 31 December 20X5, the US company purchased plant and raw materials to be used in its manufacturing process from the UK parent. Details of transactions are as follows.

	$/£
Purchase plant costing £500,000 on 30 April 20X5	1.48
Paid for plant on 30 September 20X5	1.54
Purchased raw materials costing £300,000 on 31 October 20X5	1.56
Balance of £300,000 outstanding at 31 December 20X5	1.52
Average rate for the year	1.55

The following exchange gains/losses will be recorded in the US subsidiary's profit or loss for the year ended 31 December 20X5.

	$	$
Plant costing £500,000 @ 1.48	740,000	
Paid £500,000 @ 1.54	770,000	
Exchange loss – settled transaction		(30,000)
Raw materials costing £300,000 @ 1.56	468,000	
Outstanding £300,000 @ 1.52	456,000	
Exchange gains – unsettled transaction		12,000
Net exchange loss recorded in profit or loss		(18,000)

5.8 Intercompany dividends

Dividends paid in a foreign currency during a period by a subsidiary to its parent may lead to exchange differences being reported in the parent's financial statements. This will be the case where the dividend is recognised at the transaction date, being the date on which the parent recognises the receivable, but receipt is not until a later date and exchange rates have moved during this period. As with other intra-group exchange differences, these amounts should not be eliminated on consolidation.

5.9 Disposal of a foreign operation

On the disposal of a foreign operation, the cumulative amount of exchange differences, which has been reported as other comprehensive income and is accumulated in a separate component of equity relating to the foreign operation, shall be recognised in profit or loss, along with gain or loss on disposal when it is recognised.

Disposal may occur either through sale, liquidation, repayment of share capital or abandonment of all, or part of, the entity. The payment of the dividend is part of a disposal only if it constitutes a return of the investment; for example, when the dividend is paid out of pre-acquisition profits. In the case of a partial disposal, only the proportionate share of the related accumulated exchange difference is included in the gain or loss. A write-down of the carrying amount of a foreign operation does not constitute a partial disposal. Accordingly, no part of the deferred foreign exchange gain or loss is recognised in profit or loss at the time of a write-down.

5.10 Tax effects of exchange differences

When there are tax effects arising from gains or losses on foreign currency transactions and exchange differences arising on the translation of the financial statements of foreign operations IAS 12, *Income Taxes* should be applied.

6 Disclosure

Section overview

This section presents the relevant disclosure requirements.

The disclosure requirements of IAS 21 are not particularly onerous and, assuming that an entity's functional currency has not changed during the period, and its financial statements are presented in its functional currency, it is only required to disclose the following:

- The amount of exchange differences reported in profit or loss for the period. This amount should exclude amounts arising on financial instruments measured at fair value through profit or loss under IFRS 9.
- The net exchange differences reported in other comprehensive income. This disclosure should include a reconciliation between the opening and closing amounts.

In addition, when the **presentation currency is different** from the functional currency, that fact should be stated and the functional currency should be disclosed. The reason for using a different presentation currency should also be disclosed.

Where there is a **change in the functional currency** of either the reporting entity or a significant foreign operation, that fact and the reason for the change in functional currency should be disclosed.

An entity may present its financial statements or other financial information in a currency that is different from either its functional currency or its presentation currency. For example, it may convert selected items only, or it may use a translation method that does not comply with IFRS Standards in order to deal with hyperinflation. In this situation the entity must:

- clearly identify the information as supplementary information to distinguish it from information that complies with IFRS Standards;
- disclose the currency in which the supplementary information is displayed; and
- disclose the entity's functional currency and the method of translation used to determine the supplementary information.

For publicity or other purposes, an entity may wish to display its financial statements using a currency which is neither its functional nor its presentation currency; such information is not presented in accordance with IFRS Standards, so IAS 21 requires that it should be clearly identified as being supplementary.

7 Other matters

Section overview

This section discusses a number of other matters, such as non-controlling interests and taxation.

7.1 Non-controlling interests

(a) The figure for **non-controlling interests in the statement of financial position** will be the appropriate proportion of the translated share capital and reserves of the subsidiary plus, where the NCI is valued at fair value, its share of goodwill translated at the closing rate. In addition, it is necessary to show any dividend declared but not yet paid to the NCI at the reporting date as a liability. The dividend payable should be translated at the closing rate for this purpose.

(b) The **non-controlling interest in profit or loss** will be the appropriate proportion of profits available for distribution. If the functional currency of the subsidiary is the same as that of the parent, this profit will be arrived at **after** charging or crediting the exchange differences.

(c) The **non-controlling interest in total comprehensive income** includes the NCI proportion of the exchange gain or loss on translation of the subsidiary financial statements. Where the non- controlling interest is measured at fair value, exchange gains and losses arising on the retranslation of goodwill are included in total comprehensive income.

Worked example: Consolidated financial statements

Extracts from the summarised accounts of Camrumite Inc are shown below.

Statement of financial position as at 31 December 20X3

	€
Non-current assets	10,000
Net monetary assets	5,000
	15,000
Equity	
Ordinary share capital and reserves	15,000

Statement of profit or loss for the year ended 31 December 20X3

	€
Profit for the year	3,080

Statement of changes in equity for the year ended 31 December 20X3

	€
Profit for the year	3,080
Dividend payable	1,680
Retained profit for the year	1,400

60% of the issued capital of Camrumite Inc is owned by Bates Co, a company based in the UK. There have been no movements in long-term assets during the year.

The exchange rate has moved as follows.

1 January 20X3	€5 = £1
Average for the year ended 31.12.X3	€7 = £1
31 December 20X3	€8 = £1

Requirement

You are required to calculate the figures for the non-controlling interest to be included in the consolidated accounts of Bates Co.

The non-controlling interest is measured using the proportion of net assets method.

Solution

Translating the shareholders' funds using the closing rate as at 31 December 20X3 gives €15,000 ÷ 8 = £1,875.

The non-controlling interest in the statement of financial position will be 40% × £1,875 = £750.

The dividend payable translated at the closing rate is €1,680 ÷ 8 = £210. The amount payable to the non-controlling shareholders is 40% × £210 = £84.

The profit after tax translated at the average rate is €3,080 ÷ 7 = £440. The non-controlling interest in profit is therefore 40% × £440 = £176.

The non-controlling share of the exchange difference is calculated as:

	£	£
Opening net assets		
€15,000 – €1,400 = €13,600		
At opening rate of €5: £1	2,720	
At closing rate of €8: £1	1,700	1,020
Profits of €3,080		
At average rate of €7: £1	440	
At closing rate of €8: £1	385	55
Loss on retranslation of Camrumite's accounts		1,075
NCI share of loss £1,075 × 40%		430

Therefore the non-controlling interest in total comprehensive income is profit of £176 less exchange losses of £430 = £254 loss

The non-controlling interest can be summarised as follows.

	£
Balance at 1 January 20X3 (£2,720 × 40%)	1,088
Non-controlling interest in profit for the year	176
Non-controlling interest in exchange losses	(430)
	834
Balance at 31 December 20X3	750
Dividend payable to non-controlling interest	84
	834

7.2 Tax effects

The tax effects of gains and losses on foreign currency translations are addressed by IAS 12 and covered in later chapters.

7.3 First time adoption

IFRS 1, *First Time Adoption of International Financial Reporting Standards* includes an exemption that allows the cumulative translation difference on the retranslation of subsidiaries' net assets to be set to zero for all subsidiaries at the date of transition to IFRS.

This means that it does not have to be separately disclosed and recycled in profit or loss when the subsidiaries are disposed of.

However, translation differences arising from the date of transition would have to be separately disclosed as other comprehensive income, included in a separate component of equity and reclassified to profit or loss on the investment's disposal.

In addition, the requirement to retranslate goodwill and fair value adjustments does not have to be applied retrospectively to business combinations before transition to IFRS.

8 Reporting foreign currency cash flows

Section overview

This section addresses the treatment of foreign currency cash flows in the statement of cash flows.

Transactions in foreign currency

(a) Where an entity enters into foreign currency transactions which result in an inflow or outflow of cash, the entity should translate cash flows into its **functional currency** at the **transaction date**.

(b) Although transactions should be translated at the date on which they occurred, for practical reasons IAS 21 permits the use of an average rate where it approximates to actual.

Foreign subsidiaries

A similar approach is required where an entity has a foreign subsidiary. The transactions of the subsidiary should be translated into the reporting entity's **functional currency** at the transaction date.

Reporting translation differences

Although the translation of foreign currency amounts does not affect the cash flow of an entity, translation differences relating to cash and cash equivalents are part of the changes in cash and cash equivalents during a period. Such amounts should therefore form part of the statement of cash flows. IAS 7 requires the effect of foreign currency to be reported separately from operating, investing and financing activities. No specific location for the disclosure is provided; disclosure at the base of the statement of cash flows would seem an appropriate presentation.

Where an entity adopts the indirect method of calculating cash flows from operating activities and it has foreign currency amounts which have been settled during the period, no further adjustment is required at the period end. This is because any foreign exchange difference will already include the amount of the original foreign currency transaction and the actual settlement figure. An overseas purchase will be recorded using the purchase date exchange rate and a payable will be recorded. On settlement, any adjustment to the actual cash flow paid will be recognised in profit or loss as part of the entity's operating activities.

Unsettled foreign currency amounts in relation to operating activities, such as trade receivables and payables, are not adjusted at the period end because such amounts are retranslated at the reporting date and the exchange difference is reported in profit or loss already. Where an entity uses the indirect method for calculating its operating cash flows, it starts with the profit figure which will include the retranslation difference, and the movement in the period for receivables and payables will also include a similar amount. Since the two amounts effectively eliminate each other, no adjustment is required.

Further disclosures

It is important to note that the standard requires disclosure of significant cash and near-cash balances that the entity holds but which are not available to the group as, for example, under a situation in which exchange controls prohibit the conversion of cash transactions or balances.

Worked example: Foreign currency cash flows

On 15 November, an entity imported some plant and equipment costing $400,000 from an overseas supplier, with $250,000 being paid on 31 December 20X5 and $150,000 being paid on 31 January 20X6.

The $/£ spot exchange rates were as follows.

	$/£
15 November 20X5	2.0:1
31 December 20X5	1.9:1
31 January 20X6	1.8:1

Requirement

How should these transactions be reported within the statement of cash flows?

Solution

The purchase will initially be recorded at the rate ruling at the transaction date:

$400,000 / 2.0 = £200,000, with a trade payable of the same amount also being recognised.

At 31 December 20X5, the cash outflow will be recorded at the rate ruling at the transaction date: $250,000 / 1.9 = £131,579

and the remaining trade payable, being a monetary liability, is translated at the same rate:

$150,000 / 1.9 = £78,947

The plant and equipment, a non-monetary asset, is carried at the historical rate of £200,000.

Only cash flows appear in the statement of cash flows, so £131,579 will be shown within investing activities.

9 Reporting in hyperinflationary economies

Section overview

- **IAS 29** requires financial statements of entities operating within a hyperinflationary economy to be restated in terms of measuring units current at the reporting date.
- Financial statements should be **restated based on a measuring unit current** at the reporting date:
  - **Monetary assets/liabilities** do not need to be restated.
  - **Non-monetary assets/liabilities** must be restated by applying a general prices index.
  - **Items of income/expense** must be restated.
  - **Gain/loss on net monetary items** must be reported in profit or loss.

In a hyperinflationary economy, **money loses its purchasing power very quickly**. Comparisons of transactions at different points in time, even within the same accounting period, are misleading. It is therefore considered inappropriate for entities to prepare financial statements without making adjustments for the **fall in the purchasing power of money over time**.

IAS 29, *Financial Reporting in Hyperinflationary Economies* applies to the **primary financial statements** of entities (including consolidated accounts and statements of cash flows) whose functional currency is the currency of a hyperinflationary economy. In this section, we will identify the hyperinflationary currency as $H.

The standard does not define a **hyperinflationary economy** in exact terms, although it indicates the characteristics of such an economy; for example, where the cumulative inflation rate over three years approaches or exceeds 100%.

Context example: Indicators of hyperinflation

What other factors might indicate a hyperinflationary economy? These are examples, but the list is not exhaustive.

(a) The population prefers to retain its wealth in non-monetary assets or in a relatively stable foreign currency. Amounts of local currency held are immediately invested to maintain purchasing power.

(b) The population regards monetary amounts not in terms of the local currency but in terms of a relatively stable foreign currency. Prices may be quoted in that currency.

(c) Sales/purchases on credit take place at prices that compensate for the expected loss of purchasing power during the credit period, even if that period is short.

(d) Interest rates, wages and prices are linked to a price index.

The reported value of **non-monetary assets**, in terms of current measuring units, increases over time. For example, if a non-current asset is purchased for $H1,000 when the price index is 100, and the price index subsequently rises to 200, the value of the asset in terms of current measuring units (ignoring accumulated depreciation) will rise to $H2,000.

In contrast, the value of **monetary assets and liabilities**, such as a debt for $H300, is unaffected by changes in the prices index, because it is an actual money amount payable or receivable. If a customer owes $H300 when the price index is 100, and the debt is still unpaid when the price index has risen to 150, the customer still owes just $H300. However, the purchasing power of monetary assets will decline over time as the general level of prices goes up.

9.1 Requirement to restate financial statements in terms of measuring units current at the reporting date

In most countries, financial statements are produced on the basis of either of the following:

- **Historical cost**, except to the extent that some assets (eg, property and investments) may be revalued
- **Current cost**, which reflects the changes in the values of specific assets held by the entity

In a hyperinflationary economy, neither of these methods of financial reporting are meaningful unless adjustments are made for the fall in the purchasing power of money. IAS 29 therefore requires that the **primary financial statements** of entities in a hyperinflationary economy should be produced by restating the figures prepared on either a historical cost basis or a current cost basis in terms of **measuring units current at the reporting date**.

Definition

Measuring units current at the reporting date: This is a unit of local currency with a purchasing power as at the reporting date, in terms of a general prices index.

Financial statements that are not restated (ie, that are prepared on a historical cost basis or current cost basis without adjustments) may be presented as **additional statements** by the entity, but this is discouraged. The primary financial statements are those that have been restated.

After the assets, liabilities, equity and statement of profit or loss and other comprehensive income of the entity have been restated, there will be a **net gain or loss on monetary assets and liabilities** (the '**net monetary position**') and this should be recognised separately in profit or loss for the period.

9.2 Making the adjustments

IAS 29 recognises that the resulting financial statements, after restating all items in terms of measuring units current at the reporting date, will **lack precise accuracy**. However, it is more important that certain procedures and judgements should be applied consistently from year to year.

9.3 Statement of financial position: historical cost

Where the entity produces its accounts on a historical cost basis, the following procedures should be applied.

(a) Items that are not already expressed in terms of measuring units current at the reporting date should be restated, using a **general prices index**, so that they are valued in measuring units current at the reporting date.

(b) **Monetary assets and liabilities** are not restated, because they are already expressed in terms of measuring units current at the reporting date.

(c) Assets that are **already stated at market value or net realisable value** need not be restated, because they too are already valued in measuring units current at the reporting date.

(d) Any assets or liabilities **linked by agreement to changes in the general level of prices**, such as index-linked loans or bonds, should be adjusted in accordance with the terms of the agreement to establish the amount outstanding as at the reporting date.

(e) All **other non-monetary assets**, ie, tangible long-term assets, intangible long-term assets (including accumulated depreciation/amortisation), investments and inventories, should be restated in terms of measuring units as at the reporting date, by applying a general prices index.

The **method of restating** these assets should normally be to multiply the original cost of the assets by a factor: (prices index at reporting date/prices index at date of acquisition of the asset). For example, if an item of machinery was purchased for $H2,000 when the prices index was 400 and the prices index at the reporting date is 1,000, the restated value of the long-term asset (before accumulated depreciation) would be:

$H2,000 × [1,000/400] = $H5,000

If, in the above example, the non-current asset has been held for half its useful life and has no residual value, the **accumulated depreciation** would be restated as $H2,500. (The depreciation charge for the year should be the amount of depreciation based on historical cost, multiplied by the same factor as above: 1,000/400).

If an asset has been **revalued** since it was originally purchased (eg, a property), it should be restated in measuring units at the reporting date by applying a factor: (prices index at reporting date/prices index at revaluation date) to the revalued amount of the asset.

If the restated amount of a non-monetary asset **exceeds its recoverable amount** (ie, its net realisable value or market value), its value should be reduced accordingly.

The **owners' equity** (all components) as at the start of the accounting period should be restated using a general prices index from the beginning of the period.

9.4 Statement of profit or loss and other comprehensive income: historical cost

In the statement of profit or loss and other comprehensive income, all amounts of income and expense should be **restated in terms of measuring units current at the reporting date**. All amounts therefore need to be restated by a factor that allows for the change in the prices index since the item of income or expense was first recorded.

9.5 Gain or loss on net monetary position

In a period of inflation, an entity that holds monetary assets (cash, receivables) will suffer a fall in the purchasing power of these assets. By the same token, in a period of inflation, the value of monetary liabilities, such as a bank overdraft or bank loan, declines in terms of current purchasing power.

(a) If an entity has an **excess of monetary assets over monetary liabilities**, it will suffer a loss over time on its net monetary position, in a period of inflation, in terms of measuring units as at 'today's date'.

(b) If an entity has an **excess of monetary liabilities over monetary assets**, it will make a gain on its net monetary position, in a period of inflation.

10 Audit focus

Section overview

This section provides an overview of the particular issues associated with auditing foreign subsidiaries. The audit of group accounts in general is covered in earlier chapters.

The inclusion of one or more foreign subsidiaries within a group introduces additional risks, including the following:

- Non-compliance with the **accounting requirements** of IAS 21, *The Effects of Changes in Foreign Exchange Rates*
- Potential misstatement due to the effects of **high inflation**
- Possible difficulty in the parent being able to exercise **control**, for example due to political instability
- Currency restrictions limiting payment of profits to the parent
- There may be threats to **going concern** due to economic and/or political instability
- Non-compliance with local taxes or misstatement of local tax liabilities

Audit procedures

These would include the following:

- Confirm that the balances of the subsidiary have been appropriately translated to the group reporting currency:

- Assets and liabilities at the **closing rate** at the end of the reporting period.
- Income and expenditure at the **rate ruling at the transaction date**. An average would be a suitable alternative provided there have been no significant fluctuations.

- Confirm **consistency** of treatment of the translation of equity (closing rate or historical rate).
- Verify that the **consolidation process** has been performed correctly eg, elimination of intra-group balances.
- Recalculate the **non-controlling interest**.
- Confirm that **goodwill** has been translated at the closing rate.
- Verify the **disclosure of exchange differences** as a separate component of equity.
- Assess whether **disclosure requirements** of IAS 21 have been satisfied.
- If the foreign operation is operating in a **hyperinflationary economy** confirm that the financial statements have been adjusted under IAS 29, *Financial Reporting in Hyperinflationary Economies* before they are translated and consolidated.
- Involve a specialist tax audit team to review the calculation of tax balances against submitted and draft tax returns.

Interactive question 5: Overseas subsidiary

Saturn plc trades in the UK preparing accounts to 31 March annually. Several years ago Saturn plc acquired 80% of the issued ordinary share capital of Venus Inc which trades in Zorgistan. This country is experiencing hyperinflation and severe political instability as a result. The local currency is the zorg but Venus Inc has determined that its functional currency is the US$. The presentation currency of the group is £. Venus Inc is audited by a reputable local firm of auditors.

Requirement

Identify the issues the auditor would need to consider in respect of the audit of the Saturn group financial statements.

See **Answer** at the end of this chapter.

Professional skills focus: Applying judgement

Judgement will need to be applied in this kind of question, as in real life. This is true despite the local audit firm being 'reputable' because there may be differences in local practices.

Summary

IAS 21, *The Effects of Changes in Foreign Exchange Rates*

Entity financial statements

Determine functional currency

- Primary indicators
- Secondary indicators

Group financial statements

Goodwill and fair value adjustments on acquisition of foreign subsidiary are

- Expressed in functional currency of subsidiary
- Translated at closing rate

Statement of financial position

Statement of profit or loss and other comprehensive income

Initial recognition

- Use spot exchange rate between functional and foreign currency on date of the transaction

Subsequent reporting dates

- Monetary items at closing rate
- Non-monetary items at historical cost at rate of transaction
- Non-monetary items at fair value at exchange rate when fair value determined

Exchange differences on

- Monetary items in profit or loss unless net investment in foreign currency
- Non-monetary items in other comprehensive income or profit according to where gain or loss recognised
- Net investment in foreign entity initially in other comprehensive income and income statement on disposal

Statement of cash flows

Foreign currency cash flows

- Record in entity's functional currency by applying exchange rate between functional and foreign currency at date of cash flows
- Cash flows of foreign subsidiary translated at the exchange rates between functional and foreign currency at the dates of the cash flows

IAS 29, *Financial Reporting in Hyperinflationary Economies*

Historical cost financial statements

- Statements of financial position
- Statement of profit or loss and other comprehensive income
- Gain or loss on net monetary position

Economies ceasing to be hyperinflationary

Selection and use of the general price index

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Can you determine an entity's functional currency in accordance with IAS 21? (Topic 2)
2.	How should foreign currency transactions be recognised initially and subsequently? (Topic 3)
3.	How are exchange differences on retranslation of monetary items reported under IAS 21? (Topic 3)
4.	Do you understand the rules for the translation of financial statements from the functional currency to the presentation currency? (Topic 4)
5.	What is the procedure for consolidating a foreign subsidiary? (Topic 5)
6.	How is goodwill on consolidation translated? (Topic 7)
7.	What are the issues for the auditor specific to auditing a foreign subsidiary? (Topic 10)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Zephyria	This is a very short question on which exchange rate to use when calculating goodwill on consolidation of a foreign subsidiary.
Soapstone	This tests the main calculations that will be needed for consolidation of a foreign subsidiary.
Jupiter	You are now ready to try this question, which is a full consolidated statement of financial position with a foreign subsidiary.
Winstanley	This is a typical Question 3 in the exam, approaching foreign currency from the auditors' point of view.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios to help you improve knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Earthstor (loan to Trayner only)	With regard to the loan, a sound understanding of both IAS 21 and IFRS 9 is required. You are also required to consider audit issues, particularly relating to risk.
Wadi	This question covers various financial reporting and auditing issues relating to an investment in a foreign subsidiary. As the question is highly integrated you should answer all parts of the question, paying particular attention to
	audit risk and the role of the component auditor.
Elac (trade receivables only)	This question requires you to translate the foreign trade receivables at the correct rate and calculate and present the exchange loss correctly.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving onto the next chapter.

Technical reference

1 IAS 21, The Effects of Changes in Foreign Exchange Rates

Functional currency

- Currency that influences sales prices and costs – **IAS 21.9**

Initial recognition

- Foreign currency transaction to be recorded in functional currency at spot exchange rate at date of transaction – **IAS 21.21**

Reporting at subsequent reporting dates – IAS 21.23

- Foreign currency monetary items using the closing rate
- Foreign currency non-monetary items measured at historical cost in foreign currency translated at exchange rate at date of transaction
- Foreign currency non-monetary items measured at fair value in foreign currency translated at exchange rate at date when fair value determined

Recognition of exchange differences

- Exchange differences arising on settlement or translation of monetary items at rate different from those at which they were translated on initial recognition recognised in profit or loss in period in which they arise (unless these arise in relation to an entity's net investment in a foreign operation – see IAS 21.32 below) – **IAS 21.28**
- When gain or loss on a non-monetary item is recognised directly in other comprehensive income any exchange component of gain or loss should also be recognised in other comprehensive income – **IAS 21.30**
- Exchange differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation shall be recognised: – **IAS 21.32**

- In profit or loss in the separate financial statements of reporting entity or the individual financial statements of foreign operation
- In other comprehensive income (a separate component of equity) in the consolidated financial statements and reclassified from equity to profit or loss on disposal

Change in functional currency

- Translation procedures to be applied prospectively from date of change – **IAS 21.35**

Use of presentation currency other than the functional currency

- Translation into presentation currency for consolidation – **IAS 21.38–39**

Translation of foreign operation

- Any goodwill arising on the acquisition of a foreign operation and any fair value adjustments shall be expressed in the functional currency of the foreign operation and translated at the closing rate – **IAS 21.44**

2 IAS 7, Statement of Cash Flows

Foreign currency cash flows – IAS 7.25–26

- Non-cash transactions

- The statement of cash flows does not record non-cash transactions – **IAS 7.43**

- Disclosures – **IAS 7.50**
  - Components of cash and cash equivalents – **Appendix A**
  - Reconciliation of the amounts in the statement of cash flows with the equivalent balance in the statement of financial position
  - Information (together with a commentary) which may be relevant to the users

3 IAS 29, Financial Reporting in Hyperinflationary Economies

- Scope – **IAS 29.1**
- Restatement of financial statements – **IAS 29.5–10**
- Historical cost financial statements
  - Statement of financial position – **IAS 29.11–25**
  - Statement of profit or loss and other comprehensive income – **IAS 29.26**
  - Gain or loss on net monetary position – **IAS 29.27–28**
- Current cost financial statements
  - Statement of financial position – **IAS 29.29**
  - Statement of profit or loss and other comprehensive income – **IAS 29.30**
  - Gain or loss on net monetary position – **IAS 29.31**
- Taxes – **IAS 29.32**
- Statement of cash flows – **IAS 29.33**
- Corresponding figures – **IAS 29.34**
- Consolidated financial statements – **IAS 29.35**
- Selection and use of the general price index – **IAS 29.37**
- Economies ceasing to be hyperinflationary – **IAS 29.38**
- Disclosures – **IAS 29.39–40**

Self-test questions

Answer the following questions

1 **Conversion versus translation**

What is the difference between conversion and translation of foreign currency amounts?

2 **Monetary items**

Define 'monetary' items according to IAS 21.

3 **Initial recognition**

How should foreign currency transactions be recognised initially in an individual entity's accounts?

4 **Functional currency**

What factors must management take into account when determining the functional currency of a foreign operation?

5 **Goodwill and fair value adjustments**

How should goodwill and fair value adjustments be treated on consolidation of a foreign operation?

6 **Change in functional currency**

When can an entity's functional currency be changed?

7 **Zephyria**

The Zephyria Company acquired a foreign subsidiary on 15 August 20X6. Goodwill arising on the acquisition was N$175,000.

Consolidated financial statements are prepared at the year end of 30 September 20X6 requiring the translation of all foreign operations' results into the presentation currency of pounds sterling.

The following rates of exchange have been identified:

Historical rate at the date of acquisition	N$1.321:£
Closing rate at the reporting date	N$1.298:£
Average rate for Zephyria's complete financial year	N$1.302:£
Average rate for the period since acquisition	N$1.292:£

Requirement

In complying with IAS 21, *The Effects of Changes in Foreign Exchange Rates*, at what amount should the goodwill be included in the consolidated financial statements?

8 Cacomistle

The Cacomistle Company operates in the mining industry. It acquired an overseas mining subsidiary, The Vanbuyten Company, on 10 September 20X7. The functional currency of Vanbuyten is the N$.

An initial review of the assets of Vanbuyten immediately after the acquisition found that it was necessary to make a downward fair value adjustment to the carrying amount of one of its mines amounting to N$225,000, due to adverse geological conditions. The mine had been acquired by Vanbuyten on 4 October 20X3.

Cacomistle's consolidated financial statements were prepared to 31 December 20X7 and required translation into the presentation currency which was pounds sterling.

Exchange rates were as follows:

4 October 20X3 – N$1.292: £1

10 September 20X7 – N$1.321: £1

31 December 20X7 – N$1.298: £1 Average rate for 20X7 – N$1.302: £1

Requirement

At what amount should the fair value adjustment be recognised in Cacomistle's consolidated financial statements for the year ending 31 December 20X7 according to IAS 21, *The Effects of Changes in Foreign Exchange Rates*?

9 Longspur

The Longspur Company is an aircraft manufacturer and its functional currency is pounds sterling.

Longspur ordered an item of plant from an overseas supplier at an agreed invoiced cost of N$250,000 on 31 March 20X7.

The equipment was delivered and was available for use on 30 April 20X7. It has a 10-year life span and no residual value.

Exchange rates were as follows:

31 March 20X7 – £1: N$2.10

30 April 20X7 – £1: N$2.07

31 December 20X7 – £1: N$1.90 Average rate for 20X7 – £1: N$2.05 **Requirement**

At what amount should depreciation on the equipment be recognised in Longspur's financial statements for the year ending 31 December 20X7 under IAS 21, *The Effects of Changes in Foreign Exchange Rates*?

10 Orton

The Orton Company is a retailer of artworks and sculptures. Orton has a year end of 31 December 20X7 and uses pounds sterling as its functional currency. On 28 October 20X7, Orton purchased 10 paintings from a supplier for N$920,000 each, a total of N$9,200,000.

Exchange rates were as follows:

28 October 20X7 – £1: N$1.80

19 December 20X7 – £1: N$1.90

31 December 20X7 – £1: N$2.00 8 February 20X8 – £1: N$2.40

Orton sold seven of the paintings for cash on 19 December 20X7 with the remaining three paintings being sold on 8 February 20X8. All 10 of the paintings were paid for by Orton on 8 February 20X8.

Requirement

What exchange gain arises from the transaction relating to the paintings in Orton's financial statements for the year ended 31 December 20X7 according to IAS 21, *The Effects of Changes in Foreign Exchange Rates*?

11 Alder

On 1 January 20X7 The Alder Company made a loan of £9 million to one of its foreign subsidiaries, The Culpeo Company. The loan in substance is a part of Alder's net investment in that foreign operation. The functional currency of Culpeo is the R$.

Alder's consolidated financial statements were prepared to 31 December 20X7 and the presentation currency is pounds sterling.

Exchange rates were as follows:

1 January 20X7 – R$2.00: £1

31 December 20X7 – R$1.80: £1

Requirement

How would the exchange gain or loss on the intra-group loan be recognised in the consolidated financial statements of Alder for the year ending 31 December 20X7 according to IAS 21, *The Effects of Changes in Foreign Exchange Rates*?

12 Porcupine

The Porcupine Company has a wholly owned foreign subsidiary, The Jacktree Company, with net assets at 1 January 20X7 of N$300 million. Jacktree made a profit for the year ending 31 December 20X7 of N$150 million. The functional currency of Jacktree is the N$.

Porcupine's consolidated financial statements were prepared to 31 December 20X7 and the presentation currency is pounds sterling.

Exchange rates were as follows:

1 January 20X7 – N$2.00: £1

31 December 20X7 – N$3.00: £1 Average rate for 20X7 – N$2.50: £1 **Requirement**

How would the exchange gain or loss on the investment in Jacktree be recognised in the consolidated financial statements of Porcupine for the year ending 31 December 20X7 according to IAS 21, *The Effects of Changes in Foreign Exchange Rates*?

13 Soapstone

On 31 December 20X6 The Soapstone Company acquired 60% of the ordinary shares in The Frew Company for £700. Soapstone's functional currency is pounds sterling, while Frew's is the R$.

The summarised financial statements of Frew and the £:R$ exchange rates are as follows.

	31 December 20X6	**31 December 20X7**
Identifiable assets less liabilities (= equity)	R$500	R$730
Exchange rate	£2.00: R$1	£3.00: R$1

The carrying amount of Frew's assets and liabilities are the same as their fair values and there has been no impairment of goodwill.

The average exchange rate during 20X7 was £2.50: R$1. There was no change in Frew's share capital during the year and it paid no dividends.

Requirements

Determine the following amounts that will appear in Soapstone's consolidated financial statements for the year ended 31 December 20X7 in accordance with IAS 21, *The Effects of Changes in Foreign Exchange Rates*.

(a) The carrying amount at 31 December 20X7 of the goodwill acquired in the business combination, assuming that the non-controlling interest is valued as a proportion of the net assets of the entity

(b) Soapstone's share of Frew's profit for the period

(c) The total foreign exchange gain reported as other comprehensive income in 20X7

14 Jupiter

Jupiter plc trades in the UK preparing accounts to 31 March annually.

On 31 December 20X6 Jupiter plc acquired 90% of the issued ordinary capital of Mars Inc which trades in Intergalatica where the currency is the Gal. At 31 March 20X7 the following statements of financial position were prepared.

	Jupiter plc	Mars Inc
	£'000	Gal'000
Property, plant and equipment	148,500	197,400
Financial asset investments	85,000	–
Net current assets	212,800	145,500
	446,300	342,900
Capital – ordinary £1/1 Gal	300,000	150,000
Retained earnings – at 31 March 20X7	53,300	132,900
	353,300	282,900
Long-term loans	93,000	60,000
	446,300	342,900

Relevant data is as follows.

(1) The profit of both companies accrues reasonably evenly throughout the year. Jupiter plc and Mars Inc had retained earnings of £18.9 million and 24.9 million Gal respectively for the year ended 31 March 20X7.

(2) The parent company's long-term loans include an amount borrowed from a Swiss bank (to build a new factory). 50.4 million Swiss francs were borrowed on 1 July 20X5 when the exchange rate was 2.1 francs = £1. The rate at 31 March 20X7 was 2.3 francs = £1. The loan is recorded at the historical amount received in the statement of financial position.

(3) When finalising the purchase price of Mars Inc it was agreed that non-current assets were already at fair value but that receivables required a write-down of 50,000,000 Gals. This

has not been adjusted in the books of the subsidiary. These receivables were still outstanding at 31 March 20X7.

(4) The non-current assets of Mars were acquired as follows:

	Gal'000
5 May 20X5	100,400
1 February 20X7	97,000

(5) Rates of exchange were as follows:

	Gal = £1
5 May 20X5	6.0
31 December 20X6	5.4
1 February 20X7	4.7
31 March 20X7	4.2
Average for the three months to 31 March 20X7	4.8

(6) The company has determined that goodwill at the year end has been impaired by 10% of its value in Gals. The impairment event arose on 31 March 20X7.

(7) Jupiter measures the non-controlling interest using the proportion of net assets method.

Requirement

Prepare the consolidated statement of financial position of Jupiter group as at 31 March 20X7 in accordance with IAS 21, *The Effects of Changes in Foreign Exchange Rates*.

15 Cardamom

The Cardamom Company operates in the heavy engineering sector and has the pound sterling as its functional currency.

On 30 September 20X7 Cardamom imported a crane from an overseas supplier, The Venilia Company. The total cost of the crane was R$3,000,000. Under the terms of the contract Cardamom was to pay Venilia R$2,000,000 on 31 October 20X7 and R$1,000,000 on 31 March 20X8. Cardamom does not hedge its foreign currency cash flows.

The R$/£ spot exchange rates were as follows.

	R$/£
30 September 20X7	3.0: 1
31 October 20X7	2.5: 1
31 December 20X7	2.2: 1
31 March 20X8	2.0: 1

Requirement

What should be the cash outflow in the statement of cash flows of Cardamom for the year ending 31 December 20X7 under Investing Activities in respect of the purchases of the crane, in accordance with IAS 7, *Statement of Cash Flows*?

16 Rostock

The Rostock Company operates in Sidonia and its functional currency is the N$. The Sidonian economy has deteriorated to such an extent that it became necessary for Rostock to apply IAS 29, *Financial Reporting in Hyperinflationary Economies*, with effect from 1 January 20X7. At that date Rostock's statement of financial position was summarised as follows.

	N$		N$
Property, plant and equipment	27,600	Share capital	8,000
Trade receivables	10,800	Revaluation reserve	7,000
Cash	1,300	Retained earnings	11,300
Trade payables	(13,400)		
	26,300		26,300

The share capital was issued on the date the company was formed, 1 January 20X5. The property, plant and equipment was acquired on the same date and revalued on 30 September 20X5. The trade payables were acquired on 30 September 20X6 and the trade receivables on 31 December 20X6.

The general price index of Sidonia has been as follows.

	20X5	20X6	20X7
1 January	500	700	900
30 September	600	800	
31 December	700	900	
Average for the year	580	780	

Requirement

What amount should be recognised in the statement of financial position of Rostock at 1 January 20X7 in respect of retained earnings after the adjustments required by IAS 29?

17 Winstanley International Restaurants

Winstanley International Restaurants plc (WIR) is a listed company based in the UK which operates a chain of restaurants. While most of its activities are in the UK, WIR has significant, and growing, operations in the Far East, Africa, North America and Europe. WIR's overseas activities are managed through an autonomous subsidiary in each country where WIR has restaurants.

You are a senior in the firm that audits WIR and you will be attending, in two days' time on 2 February 20X8, the final audit planning meeting in respect of the financial statements for the year ending 31 December 20X7.

The engagement Manager, Fiona Vood, has given you the following instructions ahead of the meeting:

"I realise that you have not had any previous contact with this client, but the senior who carried out the interim audit formed a personal relationship with the WIR finance director and has now left the firm. The finance director has also resigned. There are various issues with this client that worry me. I would like you to prepare a written summary of the most important concerns, as a basis for discussion at the planning meeting.

One of the areas of concern raised at the interim audit was the financial reporting treatment of foreign exchange issues. Unfortunately, a new finance director has not yet been appointed and

WIR staff have little expertise in this area. The board also has some concerns about the impact that foreign exchange movements will have on the financial statements.

I would therefore like you to provide a written explanation for the audit planning meeting of the financial reporting treatment of the matters connected with foreign exchange outlined in briefing notes 1 and 2 that I have provided (see **Exhibit**), including relevant calculations of the impact on WIR's financial statements.

I am also concerned about the current position of Landran National Restaurants (LNR), which is one of the WIR group's largest subsidiaries. As you probably know, the country of Landra has been undergoing significant economic turmoil and I'm afraid that this may be impacting on LNR. I'd be grateful if you could let me have details of the possible financial reporting issues that may affect the group's consolidated financial statements. Further details about LNR are in briefing note 3.

I'm not satisfied with the explanations the last senior obtained from the finance director about certain large payments. Details of these explanations are in briefing note 4; I reckon we need to do further work on them.

As well as the tasks I've given you above, I would also like you, for each issue 1–4 in the briefing notes, to set out a schedule which briefly describes the key audit risks and audit procedures.

Lastly, I've had an email from the Chief Executive saying that the board has decided to include a social and environmental report in the group accounts for the first time. He's wondering if we can help the company prepare the report and report on it as part of our audit. I think it may be a good idea, but I need some notes on the issues so that I can respond to the Chief Executive."

Requirement

Respond to the instructions from the engagement manager.

Exhibit: Briefing notes

(1) WIR, the parent company, made an undated loan to one of its foreign subsidiaries, Rextex Inc, of $4.8 million on 1 March 20X7. The loan was denominated in $ which is the functional currency of Rextex. WIR has made it clear that the loan is part of a long-term commitment to financing the activities of this subsidiary. The exchange rate on 1 March 20X7 was £1:$2 and the exchange rate on 31 December 20X7 was £1:$1.6. Please cover both the treatment in the group financial statements and in the WIR parent company financial statements.

(2) On 30 September 20X7 WIR purchased a cold storage depot in Lanvia in order to store food purchased from the region. The transaction had been personally authorised and dealt with by the finance director, with initial board approval. After the purchase was agreed, the finance director had visited Lanvia to take custody of the title documents. WIR does not have a subsidiary in Lanvia.

The depot contract was invoiced in Lanvian Crona (LCr) for LCr15 million. Payment was to be made in LCr in two equal instalments on 30 November 20X7 and on 31 January 20X8. As you may know, the LCr has appreciated significantly against the £ as a result of the Lanvian Government creating an independent Central Bank. Current and historical exchange rates are:

30 September 20X7 – LCr2.50/£1

30 November 20X7 – LCr2.10/£1

31 December 20X7 – LCr2.00/£1

31 January 20X8 (today) – LCr1.95/£1

During the interim audit the senior went to Lanvia to inspect the new depot and the purchase documentation.

(3) Landran National Restaurants is, in terms of revenue, WIR's second biggest subsidiary. It is a chain of high-quality restaurants, operating in the country of Landra. Over the last few years Landra has been affected by considerable economic uncertainty; inflation is currently running at 95% and is expected to go on rising rapidly for the next few years. Landra's local stock market is almost dormant; because of the impact of inflation, rich investors have preferred to invest in property in Landra or in overseas stock markets. The uncertainty has impacted significantly on LNR's business; it has been forced to link staff wages to the country's price index, and its suppliers are insisting that either LNR pays immediately in cash or, if it takes credit, that the payments are adjusted to take account of the price inflation between LNR purchasing supplies and the suppliers being paid.

    LNR's financial statements have been prepared on an unmodified historical cost basis in accordance with local accounting practice.

(4) Several large payments have been made to unidentified agents and described as commissions in respect of obtaining large catering contracts. Most of these payments have been made in cash, some of which were in foreign currencies; however, some payments have been made by cheque. Inquiries relating to the payee of the cheque have revealed that they are in the name of a nominee and the beneficiary cannot be identified. There is no supporting documentation for any of the payments.

    Before his departure the former finance director told the audit senior that such commissions are common practice and the agent represents valuable contacts whose identity must be kept confidential as otherwise WIR's competitors would be able to 'poach' work from them.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

The £ value of the loan is recorded as £4 million (€10/2.5). The UK company suffered an exchange loss of £1 million.

Answer to Interactive question 2

Assumption 1: All the tables were sold on 20 December 20X5 and were paid for on 15 December 20X5.

Statement of profit or loss

Purchases = $3,600,000 ÷ 1.8 = £2m

Purchases are recorded at the exchange rate on the date of the original transaction.

Exchange gain on settlement of payable = ($3,600,000 ÷ 1.8) – ($3,600,000 ÷ 1.9) = £105,263

The dollar has weakened between the date of the transaction and the date of settlement; so the cost of settling the trade payable in terms of pounds has reduced thereby producing an exchange gain which is recognised in profit or loss.

Statement of financial position

No balances are outstanding, as all the inventories have been sold and the trade payable is settled before the year end.

Assumption 2: All the tables were sold on 3 February 20X6 and were paid for on 15 December 20X5.

Statement of profit or loss

Purchases = $3,600,000 ÷ 1.8 = £2m

Exchange gain on settlement of payable = £105,263

The impact on profit or loss is as for Assumption 1, as the trade payable was settled on the same day.

Statement of financial position

Inventories = $3,600,000 ÷ 1.8 = £2m

All the purchases were held in inventory at the year end. As a non-monetary item, inventories remain at their original cost (ie, at the exchange rate at the date of the original purchase).

Assumption 3: All the tables were sold on 15 December 20X5 and were paid for on 3 February 20X6.

Statement of profit or loss

Purchases = $3,600,000 ÷ 1.8 = £2m

Exchange gain on year-end retranslation of payable = ($3,600,000 ÷ 1.8) – ($3,600,000 ÷ 2.0) = £200,000

The exchange gain is now determined with respect to the value of the trade payable at the year end (as a monetary item trade payables are translated at the year-end exchange rate). The dollar has weakened between the date of the transaction and the year end, so the cost of settling the trade payable in terms of pounds has reduced, thereby producing an exchange gain, which is recognised in profit or loss. The remainder of any exchange gain/loss between the year end and the date of eventual settlement is recognised in the 20X6 financial statements.

Statement of financial position

Inventories = Nil. All the inventory is sold during the year. Trade payables = ($3,600,000 ÷ 2.0)

= £1,800,000

As a monetary item, trade payables are translated at the year-end exchange rate.

Assumption 4: 75 of the tables were sold on 15 December 20X5 with the remaining 25 tables sold on 3 February 20X6. All the tables were paid for on 3 February 20X6.

Statement of profit or loss

Purchases = $3,600,000 ÷ 1.8 = £2m

Exchange gain on year-end retranslation of payable = ($3,600,000 ÷ 1.8) – ($3,600,000 ÷ 2.0) = £200,000

The explanation of the exchange gain is as for Assumption 3.

Statement of financial position

Inventories = 25% × ($3,600,000 ÷ 1.8) = £500,000

25% of the purchases were still held in inventory at the year end. As a non-monetary item these inventories remain at their original cost (ie, at the exchange rate at the date of the original purchase).

Answer to Interactive question 3

Management should value the land at £312,000 at 31 December 20X6.

The land is initially recognised at its original cost translated at the spot rate between Muritania lira and the pound (ie, £260,000) on acquisition. The value remains unchanged at 31 December 20X4 because management determined there was no need for a revaluation in this period.

At 31 December 20X5, the land is valued at £250,000, which is the fair value as at 31 December 20X5 translated at the exchange rate on the same date, when the fair value was determined (IAS 21.23). Entity A recognises a loss of £10,000 profit or loss on 31 December 20X5, because a decrease of the carrying amount as a result of a revaluation is recognised in profit or loss (IAS 16.40).

At 31 December 20X6, the land is valued at £312,000. Entity A recognises a gain of £10,000 in profit or loss. The gain of £10,000 is the reversal of the revaluation decrease as at 31 December 20X5.

The revaluation surplus of £52,000 is recognised in equity (IAS 16.39).

Answer to Interactive question 4

Petra Ltd will record its initial investment at £12,000 which is the cost of the shares (€24,000) translated at the rate of exchange on the acquisition date. The statement of financial position of Hellenic Marble at 31 December 20X6 will be:

		Exchange	
	€'000	**rate**	**£'000**
Non-monetary asset	96	3	32
Share capital and retained earnings	24		8
Loan	72	3	24
			32

The share capital and retained earnings is the balancing item and is reconciled as follows:

Translation of closing equity (€24,000 @ €3/£1)	£8,000
Translation of opening equity (€24,000 @ €2/£1)	£12,000
Loss therefore	£4,000

Answer to Interactive question 5

In relation to the financial statements of Venus Inc:

- The extent to which the work of the component auditors can be relied on. The indication is that the firm is reputable; however, differences in local practices will still need to be taken into account. Additional audit procedures may be required as a result to satisfy UK requirements.
- The accounting framework adopted and more specifically the accounting policies adopted by Venus.
- Whether the component auditors have considered the effect of the high inflation on the ability of the business to continue operating. While the functional currency of Venus is the US$, the company may not be completely immune from the effects of exchange rates for local transactions. In addition, extreme inflation may have resulted in falling sales if local sales have fallen dramatically due to lack of affordability.

In relation to the group accounts:

- The nature of the investment ie, whether the political instability in Zorgistan is such that control cannot be exercised and therefore the investment is not a subsidiary.
- Whether IAS 21 has been complied with in terms of the translation of the subsidiary's accounts into pounds.
- Materiality of the subsidiary to the group as a whole. This would be of particular relevance if the subsidiary were to face going concern issues.

Answers to Self-test questions

1 **Conversion versus translation**

Conversion is the process of physically exchanging one currency for another. Translation is the restatement of the value of one currency in another currency.

2 **Monetary items**

Money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.

3 **Initial recognition**

Use the exchange rate at the date of the transaction. An average rate for a period can be used if the exchange rates did not fluctuate significantly.

4 **Functional currency**

Primary factors used in the determination of the functional currency include the currency of the country that influences sales price for goods and services, labour, material and other costs and whose competitive forces and regulations determine these prices and costs.

Secondary indicators include the currency in which funding and receipts from operating activities arise.

5 **Goodwill and fair value adjustments**

Treat as assets/liabilities of the foreign operation and translate at the closing rate.

6 **Change in functional currency**

Only if there is a change to the underlying transactions relevant to the entity.

7 **Zephyria**

£134,823

Goodwill is translated at the closing rate. Therefore N$175,000/1.298 = £134,823. See IAS 21 IN15 and 57.

8 **Cacomistle**

£173,344

Because IAS 21.47 treats fair value adjustments to the carrying amount of assets and liabilities arising on the acquisition of a foreign operation as assets and liabilities of the foreign operation, it requires them to be translated at the closing rate.

The correct answer is thus N$225,000/1.298 = £173,344.

9 Longspur

£8,052

IAS 21.21 and 22 require that an asset should be recorded initially at the date of the transaction, which is the date it first qualifies for recognition. For property, plant and equipment, this is when the asset is delivered, which in this case is 30 April 20X7.

The equipment is a non-monetary asset and thus its carrying amount stays at the original translated value per IAS 21.23(b). Depreciation on a non-monetary asset is charged from when it becomes available for use and is treated in the same way as the related assets, so there is no change from the exchange rate at initial recognition. The correct answer is therefore:

(N$250,000/10 years) × 8/12 = N$16,667 translated at £1:N$2.07 = £8,052.

10 Orton

£511,111

Exchange gain = (N$9,200,000/1.8) – (N$9,200,000/2.0) = £511,111

The exchange gain is determined with respect of the value of the trade payable at the year end (as per IAS 21.23(a) monetary items such as trade payables are translated at the year-end exchange rate). The N$ has weakened between the date of the transaction and the year end, so the cost of settling the trade payable in terms of £ has reduced, thereby producing an exchange gain.

There is no gain or loss in respect of the revenue for the paintings sold, which is recorded at the transaction date rate (IAS 21.21). There is no gain or loss on the paintings held in inventory which in the year-end statement of financial position are translated at the transaction date rate (IAS 21.23(b)).

11 Alder

The loan would initially be recorded in the financial statements of Culpeo at the rate ruling on the transaction date (IAS 21.21), so £9m × 2.0 = R$18m. Under IAS 21.23 the amount payable at the year end is £9m × 1.8 = R$16.2m. The difference is a gain (ie, reduction in a liability) of R$1.8 million in the financial statements of Culpeo.

This gain will be translated at the closing rate and is equal to £1.0 million (R$1.8m/1.8). Since the loan is part of the net investment, it is recognised as a separate component of equity as required by IAS 21.15 and IAS 21.32–33.

12 Porcupine

£60 million loss, recognised in equity

IAS 21.39 and 41 require that exchange differences in translation to the presentation currency are recognised directly in equity.

		£m	£m
Net assets at 1 January 20X7 at last year's rate	N$300 @ 2.0	150	
Net assets at 1 January 20X7 at this year's rate	N$300 @ 3.0	100	50 loss
Profit at average rate	N$150 @ 2.5	60	
Profit at 31 December 20X7	N$150 @ 3.0	50	10 loss
			60 loss

13 Soapstone

(a) The goodwill acquired is calculated as:

	R$
Consideration transferred (£700/2)	350
Non-controlling interest (R$500 × 40%)	200
	550
Net assets of acquiree	(500)
Goodwill	50
Translated at acquisition (R$50 × 2) =	£100
Retranslated at 31 December 20X7 (R$50 × 3) =	£150

(b) As there has been no change in Frew's share capital during 20X7, the (R$730 – R$500) = R$230 increase in equity represents Frew's profit for 20X7. This is translated at the £2.50: R$1 average rate as an approximation to the rates ruling at the date of each transaction, to give £575, of which Soapstone's 60% share is £345 (IAS 21.39(b)–40).

(c) The amount reported as other comprehensive income is made up of the exchange difference on the retranslation of Frew's accounts plus the exchange difference on the retranslation of goodwill:

Retranslation of Frew's accounts

		£	£
Net assets at 1 January 20X6 at opening rate	R$500 @ 2.0	1,000	
Net assets at 1 January 20X6 at closing rate	R$500 @ 3.0	1,500	500 gain
Profit at average rate	R$230 @ 2.5	575	
Profit at closing rate	R$230 @ 3.0	690	115 gain
			615 gain

Retranslation of goodwill

£150 – £100 = £50 gain (part (1))

The overall exchange gain recognised as other comprehensive income is therefore £615 + £50 = £665.

Of this:

- £615 × 40% = £246 is attributable to the non-controlling interest
- (£615 × 60%) + £50 = £419 is attributable to the shareholders of the parent

14 Jupiter

Consolidated statement of financial position as at 31 March 20X7

	£'000
Tangible non-current assets (148,500 + 47,000)	195,500
Goodwill (W4)	54,641
Net current assets (212,800 + 22,738)	235,538
	485,679

Share capital	300,000
Retained earnings (W5)	50,484
Foreign exchange reserve (W6)	24,451
	374,935
Non-controlling interest (W7)	5,545
Long-term loans (90,913 (W3) + 14,286)	105,199
	485,679

WORKINGS

(1) **Translation of the statement of financial position of Mars Inc**

	Gal'000	Gal'000	Rate	£'000
Tangible non-current assets		197,400	4.2 CR	47,000
Net current assets	145,500			
Less receivables w/d	50,000			
		95,500	4.2 CR	22,738
		292,900		69,738
Share capital		150,000	5.4 HR	27,778
Pre-acquisition reserves (W2)		76,675	5.4 HR	14,199
Post-acquisition reserves (24,900 × 3/12)		6,225	ß	13,475
(incl exchange differences to date)		232,900		55,452
Long-term liabilities		60,000	4.2 CR	14,286
		292,900		69,738

(2) **Pre-acquisition reserves**

	Gal'000
Balance at 31 March 20X7	132,900
Less earnings post-acquisition (24,900 × 3/12)	(6,225)
Reserves at 31 December 20X6	126,675
Less write-down of receivables	(50,000)
Pre-acquisition reserves	76,675

(3) **Jupiter plc loans (retranslated at closing rate)**

	£'000	£'000
Long-term liability per SFP		93,000
Revaluation of Swiss franc loan		
SF50.4m / 2.1	24,000	
SF50.4m / 2.3	(21,913)	
Gain on remeasurement		2,087
Remeasured long-term liabilities		90,913

(4) **Goodwill**

	Gal'000		£'000
Consideration transferred (£85m × 5.4)	459,000		
Non-controlling interest			
(Gal 150m + Gal 76.675m) × 10%	22,668		
	481,668		
Net assets of acquiree (150m + 76.675m)	(226,675)		
Goodwill	254,993	@ HR 5.4	47,221
Impairment	(25,499)	@ CR 4.2	(6,071)
Exchange gain (β)			13,491
Carrying value	229,494	@ CR 4.2	54,641

Proof of exchange gain:		£'000
Initial value of goodwill Gal 254,993,000	@ HR 5.4	47,221
	@ CR 4.2	60,712
Overall exchange gain		13,491

(5) **Consolidated retained earnings**

	£'000
Jupiter plc	53,300
Share of post-acquisition profits in Mars	
(90% × Gal 24.9m × 3/12m) @ AR 4.8	1,168
Gain on Swiss franc loan (W3)	2,087
Impairment of goodwill (W4) (25,499/4.2)	(6,071)
	50,484

(6) **Foreign exchange reserve**

	£'000
Exchange gain on goodwill (W4)	13,491
Group share of exchange gain on retranslation of subsidiary (W8)	10,960
	24,451

(7) **Non-controlling interest (from W1)**

	£'000
10% × (69,738 – 14,286)	5,545

(8) **Exchange difference on retranslation of subsidiary**

		£'000	£'000
Opening net assets (acquisition) Gal 226,675,000	@ HR 5.4	41,977	
	@ CR 4.2	53,970	Gain 11,993
Retained profits since acquisition			
Gal 24.9m × 3/12 = Gal 6.225m	@ AR 4.8	1,297	
	@ CR 4.2	1,482	Gain 185
			Gain 12,178
Group share £12,178,000 × 90%			10,960

15 Cardamom

£800,000

IAS 7.25 requires cash flows from foreign currency transactions to be recorded by reference to the exchange rate at the date of the cash flow.

Only the October 20X7 flow falls within the year ended 31 December 20X7, so the outflow is R$2,000,000 at 2.5 = £800,000

16 Rostock

N$25,700

The only asset requiring adjustment is the PPE, from date of revaluation to 1 January 20X7, so it is restated to N$41,400 (N$27,600 × 900/600) (IAS 29.18). The other assets and the trade payables are monetary items which require no adjustment (IAS 29.12). So the restated equity is N$40,100 (N$41,400 – N$27,600 + N$26,300).

At the beginning of the first period of application of IAS 29, share capital is restated from the date of contribution, the revaluation surplus is eliminated and retained earnings are the balancing figure (IAS 29.24). Retained earnings are N$25,700 (N$40,100 – N$8,000 × 900/500).

17 Winstanley International Restaurants

To Fiona Vood

From A Senior

Date 31 January 20X8

Subject Winstanley Audit – International transactions and balances

Parent company loan

(1) **Financial reporting**

Where a parent company makes a loan to a subsidiary then the amount outstanding is an intra- group monetary item. The entity with the currency exposure needs to recognise an exchange difference on the intra-group balance. In this case, as the loan is denominated in dollars, then the currency risk lies with WIR rather than Rextex.

(a) **Parent company financial statements**

The loan is a monetary item. The normal rules of IAS 21 apply in the case of the parent company accounts. Assuming that the £ is the functional currency of WIR (as 'most of its activities are in the UK') then the exchange difference should be recognised in profit or loss.

Specifically there is a foreign exchange gain on the loan receivable of £600,000 [($4.8m/2) – ($4.8m/1.6)]

The receivable will thus be recorded in the WIR individual company statement of financial position at £3 million.

It is possible that the loan may have been eligible to be treated as a fair value hedge of exchange rate risk of the investment, but it does not appear that adequate documentation was put in place at inception.

(b) **Consolidated financial statements**

In the consolidated financial statements the loan from a parent to a subsidiary can be regarded as part of a net investment in a foreign operation. This is only permitted by IAS 21 where settlement is neither planned nor likely to occur in the foreseeable future.

As the WIR loan is undated, and there is no intention for repayment in the short or medium term, it would therefore appear that the loan to Rextex qualifies as a net investment in a foreign operation.

As a consequence, IAS 21 requires that the exchange gain of £600,000 recognised in profit of the WIR parent company accounts must, on consolidation, be removed from consolidated profit or loss, recognised as other comprehensive income and recorded in equity in the combined statement of financial position.

(2) **Audit risk and audit procedures**

A key risk is that the loan from WIR to Rextex fails the IAS 21 test for a net investment in a foreign operation. The consequence of this would be that the loan would be a normal monetary item and the exchange gain taken to profit in the consolidated financial statements in the normal way.

The key audit risks are that:

- the loan might be improperly classified and thus the exchange gain on the loan wrongly recognised as other comprehensive income; and
- the company may wish the exchange gain to be recognised in profit or loss (rather than as other comprehensive income) and therefore change the terms of the loan before the year end in order to make it more temporary. It would thus not be treated as a net investment in a foreign subsidiary.

Other audit risks and audit procedures are as follows:

Audit risks	Audit procedures
Use of inappropriate exchange rates	Verify exchange rates by confirming dates of the initial loan agreement and funds transfer
Consider any impairment of loan	Review going concern of Rextex (budgets, liquidity, cash flow)
Review terms of loan for evidence of permanency or ability of WIR directors to change the terms of the loan in the near future	Review correspondence between WIR and Rextex and board minutes for evidence that the loan may be repayable in the near future Review the terms of the loan
Post year end changes in exchange rates affecting loan value	Verify exchange rates after the end of the reporting period. If material consider disclosure as a non-adjusting event per IAS 10

Purchase of warehouse

(1) **Financial reporting**

According to IAS 21 an entity is required to translate foreign currency items and transactions into its functional currency.

WIR initially records both the non-current asset and the liability at £6 million (LCr15m/2.5).

		£m	£m
DEBIT	Warehouse – non-current asset	6	
CREDIT	Liability		6

The non-current asset needs no further translating.

By the date of the first payment there has been an appreciation in the LCr against the £. As a result the actual amount in £s that WIR needs to settle the first instalment will increase, thereby resulting in an exchange loss.

Amount required to settle is LCr7.5m/2.1 = £3,571,429 The exchange loss is thus £571,429

(£3,571,429 – £3m)

The remainder of the liability is still outstanding at the year-end date. As a monetary liability, it needs retranslating at the rate of exchange ruling at the reporting date as £3.75 million (ie, LCr7.5m/2).

The resulting exchange loss of £750,000 (ie, LCr7.5m/2.5 – LCr7.5m/2) should be shown as part of profit or loss.

The settlement date and exchange rate on that date are not relevant for the financial statements of the year ending 31 December 20X7.

(2) **Audit risk and audit procedures**

Audit risks	Audit procedures
There are concerns over the role of the FD due to the following: • The resignation in the year	Interview other board members and finance staff to assess competence, integrity and degree of control exercised by the FD

Audit risks	Audit procedures
• The personal relationship with the last audit senior • Personal control over the acquisition of a major asset • The 'commissions' paid (discussed further below) • There is no replacement FD yet in post	Review samples of transactions authorised by the FD Review the measures taken to compensate for the absence of an FD
Internal controls over the transaction – given major involvement of FD	Review board minutes for authorisation Speak to members of the board and finance staff to assess role of the ex-FD in the contract (was there any meaningful segregation of duties?) Re-examine audit working papers of previous audit senior given personal involvement. Consider reperforming audit procedures
Timing of payments	Review contract to ascertain payment terms and dates. Verify actual payments made after they have occurred
Business risk – impairment	Given the doubts over the FD, ascertain the business case for warehouse (ie, why it was needed in this location) and assess its fair value on the basis of (i) any independent valuations carried out during purchase process (ii) utilisation of the warehouse since purchase (eg, amount of inventories held there).

Landra – hyperinflationary economy

(1) **Financial reporting issues**

Landra appears to have several of the characteristics of a hyperinflationary economy:

- Many of the richest people in Landra are accumulating wealth in property, or investing it in stable markets overseas.
- Suppliers are adjusting the credit payments required from LNR.
- The staff in Landran restaurants are having to be paid in amounts linked to a price index.
- Based on the information available, inflation is likely to exceed 100% over three years.

If Landra is judged to be a hyperinflationary economy, then the financial statements of LNR will have to be restated before they are translated into WIR's currency for consolidation purposes. The historical cost financial statements will have to be stated in terms of the measuring units current at the reporting date.

(2) **Audit risks and audit procedures**

The decision on whether the accounts should be translated because the Landran economy is hyperinflationary is not always straightforward. IAS 29 does not specify a cut-off point in terms of an exact rate but gives examples of indications that hyperinflation exists. IAS 29 also indicates that precise accuracy in restating amounts is not possible, but what is important is consistent application of its principles. Thus if the accounts are restated, the expectation should be that they will be restated for a number of years. The adjustments required will need to be verified.

In addition, the poor economic conditions in the country may cast doubt on whether the subsidiary can continue to operate as a going concern. As an upmarket chain of restaurants, it may be badly hit by the economic problems.

Audit risks and audit procedures may include:

Audit risks	Audit procedures
Landra may be incorrectly treated as a hyperinflationary economy	Examine economic forecasts by bodies such as the Bank of England for information about future economic trends in Landra, particularly the rate of inflation Obtain information about the Landra Government's current economic policies, in particular any plans they have to reduce inflation Review reports and press coverage of the situation in Landra and attempt to ascertain whether the problems LNR is facing are widespread
Adjustments may be calculated wrongly	Assess whether the price index used to make IAS 29 adjustments is a reliable indicator of inflation, and ascertain the reasons for the choice made if index used is not Landran consumer prices index Assess whether the classification of statement of financial position items into monetary and non-monetary for the purposes of making adjustments is appropriate Ascertain whether non-monetary items in the statement of financial position, the statement of profit or loss and relevant items in the statement of cash flows have been adjusted into measuring units current at the end of the reporting period Reperform the adjustment calculations and verify the adjustments used to the price index Ensure that monetary items, and other assets stated at market value or net realisable value, have not been adjusted (already expressed in terms of the monetary unit current at the end of the reporting period) Reperform the calculation of monetary gain or loss Confirm that the comparative figures have been restated in line with current measuring units Confirm that the consolidated accounts fulfil the disclosure requirements of IAS 29
LNR may be wrongly treated as a going concern	Obtain budget and forecast information and review for signs of cash shortages Consider whether the assumptions take appropriate account of current economic difficulties in Landra Ascertain whether LNR directors' assessment of going concern extends to 12 months from the date of the financial statements and request assessment be extended to this length if not

Audit risks	Audit procedures
	Also consider the UK-specific requirement that the directors should disclose if their going concern assessment covered a period less than one year from the date of the approval of the financial statements, in which case this should be disclosed in the auditor's report Assess the availability of local finance if LNR is likely to require it Obtain written representations from WIR's directors of plans by WIR to provide financial support for LNR Assess the likely effectiveness of any other plans that LNR's directors have to deal with going concern difficulties Assess whether uncertainties that exist about the future of LNR are material in the context of the group financial statements Consider the need for adjustments to the figures consolidated if the going concern basis is not appropriate for LNR Consider the need for modification of the audit opinion on the grounds of material misstatement or the inclusion of a 'Material Uncertainty Related to Going Concern' section

Payments to agents

(1) **Audit risk and audit procedures**

Even if the commission payments are legal, the accounting records that relate to these payments are inadequate, and we only have the unsupported word of the ex-FD. This does not represent sufficient evidence by itself; we should expect to see stronger evidence in the form of proper payment records. Now that the FD has left, no one else may have any knowledge about what the payments are for.

In addition, what the FD described as commissions for obtaining work may in fact be bribes. The lack of documentation means that we cannot be certain that the payments are in fact commissions. They may represent a diversion of funds to the FD or possibly money laundering.

The fact that the FD was able to make these payments without anyone checking also casts doubt on how effective the rest of the board has been in monitoring the effectiveness of the internal control systems. Although as auditors we do not have to give an opinion on the effectiveness of internal controls, we do have to assess the review carried out by the directors. We also need to consider the strength of the evidence of representations by the board, since the failure to control the FD may indicate a lack of knowledge of key accounting areas.

The main audit risks and procedures include the following:

Risks	Audit procedures
Money paid to payees who have no entitlement to them	Ascertain details about the nominee payees, through internet searches or through international contacts Having gained the client's permission, attempt to contact the payees and ask for an explanation of these payments Discuss the legal position with the current directors, pointing out that the audit report may need to be qualified on the grounds of

Risks	Audit procedures
	failure to provide explanations If possible, obtain written representations from other directors; however, directors may not be able to provide those representations and even if they can, the representations by themselves will not be sufficient audit evidence Ask the directors to encourage other staff to disclose any knowledge they have of these payments, pointing out that auditors have an obligation to keep legitimate business matters confidential Consider issuing a qualified opinion or disclaimer on grounds of uncertainty because of an inability to obtain sufficient appropriate evidence. Also consider reporting by exception on failure to keep proper accounting records Consider issuing a qualified audit opinion on the grounds of material misstatement or an adverse opinion if the accounts do not fairly reflect what the payments appear to be
Bribery/money laundering	Ascertain whether payments can be linked to specific bookings or specific contracts Identify the countries to which the payments are being sent, and ascertain whether doubtful business practices are widespread there Examine expenditure in other categories where reasons for expenditure appear doubtful or payees are unclear Consider taking legal advice or reporting to the proper authority if there appears to be suspicion of illegal activity, or it is in the public interest to do so (clearly, tipping off should be avoided)
Corporate governance insufficiently/incorrectly described in accounts	Review board's statement about the review of internal control effectiveness (assuming one has been carried out) and consider whether it fairly reflects what has taken place Review disclosures of processes dealing with internal control problems such as the payments authorised by the finance director and consider whether disclosures fairly describe these processes Consider whether the directors have sufficient knowledge to be able to make representations required for audit

Social and environmental statement

(1) **Ethical issues**

Helping the client on the social and environmental report is likely to be recurring work. We should therefore first assess whether this work, together with the other work we do for the client, would earn us fees that are greater than 10% of total practice or partner fees, and would therefore be a self-interest threat. In addition we need to consider whether the provision of the non-audit work would breach the 70% benchmark in relation to average fees paid in the last three consecutive years.

Secondly, we should consider carefully the work we are being asked to do. Helping management to prepare a policy statement might constitute a threat to independence on a number of grounds. Even if our work was limited to preparing factual statements and analysis, we would still face a threat to independence. As auditors we would be checking the consistency of a statement we helped prepare against the financial statements. If we had a more active role, helping management prepare commentary and statements of opinion, we could be accused of acting as the client's advocate.

Our work should therefore be confined to reporting on the statement that management prepares. However, we need to consider whether we have the knowledge and competence necessary to issue an opinion in the terms the client wants, and to carry out the work necessary to support that opinion.

In addition, the audit committee should have ultimate responsibility for deciding whether we can provide non-audit services, not the board. Part of the audit committee's remit under governance guidance is to assess annually the independence of the external auditors, and specifically assess for each non-audit service the competence of the audit firm to provide it and the safeguards in place to stop it compromising its independence.

(2) **Audit and assurance issues**

Reporting on the statement should not be considered as part of the audit. Instead we should treat it as an assurance engagement and issue a separate engagement letter in respect of it.

As auditors we are appointed to report on the financial statements. The social and environmental report is not part of the financial statements; instead it will be one of the documents issued with the financial statements. As such, our responsibility is to read it to identify any material inconsistencies with the financial statements. We are not required to express an opinion on the contents of this report.

Although social and environmental issues will have some impact on the audit, this is only insofar as they affect the financial statements. Possible impacts include contingent liabilities and provisions in respect of legal action, or expenditure on cleaning up sites. There are likely to be a number of other aspects of the report which will not impact on the financial statements and we therefore would not consider these.

We thus need to undertake additional work to be able to issue a full report on social and environmental issues. The work we do and the content of the report would depend on the terms of the engagement. The report is likely to include as a minimum:

- the objectives of the review
- opinions
- basis on which the opinions have been reached
- work performed

Chapter 22

Income taxes

Introduction

Learning outcomes

- Explain, determine and calculate how current and deferred tax is recognised and appraise accounting standards that relate to current tax and deferred tax
- Justify and conclude for a particular scenario what comprises sufficient, appropriate audit evidence
- Design and determine audit procedures in a range of circumstances and scenarios, for example identifying an appropriate mix of tests of controls, analytical procedures and tests of details
- Demonstrate and explain, in the application of audit procedures, how relevant ISAs affect audit risk and the evaluation of audit evidence

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
1	**Current tax revised** Taxation is a major expense for business entities and has a direct effect on cash flow and performance.	**Approach** This section gives a brief overview of the material that you have covered at Professional Level on current tax. **Stop and think** How should excess tax paid be reported?	It is important to study this section carefully in order to get you thinking about the differences between accounting and taxable profit, which you need to know about in order to calculate current tax. Current tax may be tested in its own right, for example in June 2020, and in addition, this thought process will be helpful to you in calculating deferred tax.	N/A
2	**Deferred tax – an overview** Corporate income taxes are a means by which governments provide incentives	**Approach** You have studied current tax at Professional Level, but deferred tax is new to Advanced	This overview could not be tested directly in an exam. Please note, before getting into the detail, that any tax	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
	for companies to act in a particular way, for example beneficial tax credits to encourage research and development and allowances to encourage investment. Therefore, although taxable profit is based on accounting profit, there are often important differences.	Level, so you should focus on deferred tax. Focus on the overview of the calculation in paragraph 2.3. **Stop and think** What are temporary differences?	rules will be given to you in an exam. You are not required, for the purposes of this exam, to know the UK tax rules or those of any other country.	
3	**Identification of temporary differences** Accounting for these types of differences is the major emphasis of this chapter.	**Approach** Read the introduction to identifying temporary differences, focusing on the summary table. Make sure you understand the definitions. **Stop and think** When is the tax base of an asset or liability equal to its carrying amount?	As you will have seen in previous chapters, IAS 12 can be examined in the context of other IFRS® Standards, for example on pensions, share-based payment, revaluations or leases.	**IQ1: Tax base** A series of short questions covering a number of the situations you are likely to meet.
4	**Measurement of deferred tax assets and liabilities** This section goes into more depth on the calculations.	**Approach** Focus on the worked examples, particularly the one on recovery/settlement. **Stop and think** What does 'substantively enacted' mean?	Deferred tax assets often come up in the context of pensions.	**IQ2: Recovery 1** This question contrasts recovery through continued use and recovery through sale.
5	**Recognition of deferred tax in the financial statements** There will be a deferred tax liability (usually) or asset in	**Approach** Study the worked example in section 5.1 and 5.2 (the deferred tax asset).	Occasionally you will get a scenario where a deferred tax asset has been wrongly calculated and you are	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
	the statement of financial position and a corresponding debit (usually) in profit or loss, other comprehensive income or goodwill.	**Stop and think** When can we be sure that sufficient taxable profit will be available to use against a deductible temporary difference?	required to correct this.	
6	**Common scenarios** Common scenarios in which a deferred tax asset or liability might arise include but are not limited to: • accelerated capital allowances • interest revenue • development costs • revaluations • retirement benefits • share-based payment	**Approach** The scenarios come with explanations and in most cases with a worked example. Work through them carefully. **Stop and think** Why do temporary differences arise in respect of retirement benefits?	Any of these scenarios could be examined, particularly share-based payment and retirement benefits, as these areas were not tested at Professional Level.	**IQ5: Share option scheme and deferred tax** This question revises your knowledge of IFRS 2, which you studied in Chapter 19, but also tests the deferred tax aspects.
7	**Group scenarios** Adjustments are made on consolidation to the carrying amounts of assets and liabilities which are not always reflected in the tax bases of those items, so temporary differences arise.	**Approach** You will be familiar with fair value adjustments on consolidation. Temporary differences arise on this, giving rise to deferred tax, which also affects goodwill. **Stop and think** When will deductible temporary differences arise in a group context?	The most common group deferred tax issue to be tested is fair value adjustments on consolidation.	**IQ10: Deferred tax scenarios** As well as testing deferred tax in a group context, this comprehensive question also tests other deferred tax issues, so is a priority, although ideally you should do all the interactive questions.
8	**Presentation and disclosure** This section gives the disclosures for both current and deferred tax.	**Approach** Read and highlight. **Stop and think** Why might deferred tax give rise to prior period adjustments?	Disclosures could be tested.	**IQ12: Tax adjustment** This question tests the interaction between IAS 12 and IAS 8.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
9	**Deferred tax summary and practice** This has been a long chapter so it is useful to have a section summarising what you have learned so far.	**Approach** Read through and absorb the table, going back to the body of the chapter if anything is unclear. Then try the interactive question. **Stop and think** When would you offset deferred tax assets and liabilities?	The exam-standard interactive question is indicative of how deferred tax will be tested in conjunction with other standards.	**IQ13: Exam-standard question** While deferred tax is tested extensively in this question, so are the scenarios where it arises, so the question revises your knowledge of other standards relating to those scenarios.
10	**Audit focus** As often with auditing, the focus is on risk. Management judgements are involved, and the auditor needs to check that these are reasonable.	**Approach** Read through this short section carefully, paying particular attention to the use of tax specialists. Focus on the case study, which gives this subject a practical relevance. **Stop and think** Why are foreign groups particularly risky?	You could get an integrated question in which deferred tax was minimised in order to make the gearing figure more favourable. This would give rise to ethical issues.	N/A

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Current tax revised

Section overview

Current tax is the amount payable to the tax authorities in relation to the trading activities of the current period.

1.1 Background

Accounting for current tax is ordinarily straightforward. Complexities arise, however, when we consider the future tax consequences of what is going on in the financial statements now. This is an aspect of tax called deferred tax, which has not been covered in earlier studies and which we will look at in the next section. IAS 12, *Income Taxes* covers both current and deferred tax. The parts of this Workbook relating to current tax are fairly brief, as this has been covered at Professional Level.

1.2 Recognition of current tax liabilities and assets

Current tax is the amount payable to the tax authorities in relation to the current trading activities. IAS 12 requires any **unpaid tax** in respect of the current or prior periods to be recognised as a **liability**. Conversely, any **excess tax** paid in respect of current or prior periods over what is due should be recognised as an asset to the extent it is probable that it will be recoverable.

The tax rate to be used in the calculation for determining a current tax asset or liability is the rate that is expected to apply when the asset is expected to be recovered, or the liability to be paid. These rates should be based on tax laws that have already been enacted (are already part of law) or substantively enacted (have already passed through sufficient parts of the legal process that they are virtually certain to be enacted) by the reporting date.

1.3 Measurement

Measurement of current tax liabilities (assets) for the current and prior periods is very simple. They are measured at the **amount expected to be paid to (recovered from) the tax authorities**. The tax rates (and tax laws) used should be those enacted (or substantively enacted) by the reporting date.

1.4 Recognition of current tax

Normally, current tax is recognised as income or expense and included in the net profit or loss for the period. However, where tax arises from a transaction or event which is recognised **as other comprehensive income** or recognised **directly in equity** (in the same or a different period) rather than in profit or loss, then the related tax should also be reported within other comprehensive income or reported directly in equity. An example of such a situation is where, under IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, an adjustment is made to the **opening balance of retained earnings** due to either a change in accounting policy that is applied retrospectively, or to the correction of a material error. Any related tax is therefore also recognised directly in equity.

1.5 Presentation

In the statement of financial position, **tax assets and liabilities** should be shown separately.

Current tax assets and liabilities may only be **offset** under the following conditions.

- The entity has a **legally enforceable right** to set off the recognised amounts.
- The entity intends to settle the amounts on a **net basis**, or to realise the asset and settle the liability at the same time.

The **tax expense (income)** related to the profit or loss from ordinary activities should be shown on the face of the statement of profit or loss and other comprehensive income as part of profit or loss for the period. The **disclosure requirements** of IAS 12 are extensive and we will look at these later in the chapter.

2 Deferred tax – an overview

Section overview

- Deferred tax is an accounting measure used to match the tax effects of transactions with their accounting impact and thereby produce less distorted results. It is not a tax levied by the Government that needs to be paid.
- You have studied current tax at Professional Level, but deferred tax is new to Advanced Level, so you should focus on deferred tax.

2.1 What is deferred tax?

When a company recognises an asset or liability, it expects to **recover or settle the carrying amount**
of that asset or liability. In other words, it expects to sell or use up assets, and to pay off liabilities. What happens if that recovery or settlement is likely to make future tax payments larger (or smaller) than they would otherwise have been if the recovery or settlement had no tax consequences? In these circumstances, IAS 12 requires companies to recognise a **deferred tax liability** (or **deferred tax asset**).

Note: Deferred tax is not a tax that the entity pays. It is an **accounting measure**, used to match the tax effect of transactions with their accounting effect.

2.2 Accounting profits vs taxable profits

Although **accounting profits** form the basis for computing **taxable profits**, on which the tax liability for the year is calculated, **accounting profits** and **taxable profits** are often different for two main reasons:

(a) Permanent differences

(b) Temporary differences

2.2.1 Permanent differences

These arise when items of revenue or expense included in the accounting profit are excluded from the computation of taxable profits. For example, income or expense items that are not allowed by tax legislation e.g., fines or penalty and tax credits for some expenditures which directly reduce taxes. Note that IAS 12 does not refer to the term 'permanent differences'; this is a term used in GAAP.

2.2.2 Temporary differences

These arise when items of revenue or expense are included in both accounting profits and taxable profits, but not in the same accounting period. For example, both depreciation and capital allowances write off the cost of a non-current asset, though not necessarily at the same rate and over the same period.

Context example: Temporary differences 1

A company buys an item of machinery on the first day of the financial year, 1 January 20X0, at a cost of £100,000 and applies straight-line depreciation at a rate of 10%. Capital allowances are available at 20% reducing balance.

y/e 31 December	Depreciation (10% SL)	Capital allowances (20% RB)
20X0	£10,000	£20,000
20X1	£10,000	£16,000
20X2	£10,000	£12,800
20X3	£10,000	£10,240 and so on

Therefore in 20X0, accounting profits are reduced by £10,000 but taxable profits are reduced by £20,000, so providing one reason why the tax charge is not equal to the tax rate multiplied by the accounting profit.

At this point it could be said that the temporary difference is equal to the £10,000 difference between depreciation and capital allowances.

In the long run, the total taxable profits and total accounting profits will be the same (except for permanent differences). In other words, temporary differences which originate in one period will reverse in one or more subsequent periods.

Deferred tax is an accounting adjustment to smooth out the discrepancies between accounting profit and the tax charge caused by **temporary differences.**

2.3 Calculating and accounting for deferred tax

In order to calculate deferred tax, the following steps must be taken:

(a) Identify temporary differences.

(b) Apply the tax rate to the temporary differences to calculate the deferred tax asset or liability.

(c) Recognise the resulting deferred tax amount in the financial statements.

Identification of temporary differences

Above we have considered temporary differences as being the result of income or expenditure being recognised in accounting and taxable profit in different periods.

IAS 12, however, requires that a 'net assets approach' rather than an 'income statement approach' is taken to calculate temporary differences.

Applying this approach to the illustration seen above, we would simply compare the carrying amount and the tax written-down value rather than depreciation and capital allowances in order to calculate the temporary difference:

	£
Carrying amount (£100,000 – £10,000)	90,000
Tax written-down value (£100,000 – £20,000)	80,000
Temporary difference	10,000

The identification of temporary differences is covered in more detail in section 3.

Apply the tax rate to temporary differences to calculate deferred tax asset or liability

The tax rate to be used is not necessarily the current tax rate. It should be the rate which is expected to apply to the period when the asset is realised or liability settled.

This is covered in more detail in section 4.

Record deferred tax in the financial statements

Depending on the circumstances, a deferred tax asset or liability may arise in the statement of financial position. The corresponding entry is normally recorded in:

- the tax charge in profit or loss; or
- other comprehensive income.

This is covered in more detail in section 5.

3 Identification of temporary differences

Section overview

Temporary differences are calculated as the difference between the carrying amount of an asset or liability and its tax base. Temporary differences may be classified as:

- taxable
- deductible

3.1 Calculation of temporary differences

Temporary differences are calculated as the difference between:

- the **carrying amount** of the asset or liability in the statement of financial position; and
- the '**tax base'** of the asset or liability.

3.1.1 Tax base

Definition

Tax base: The amount attributed to an asset or liability for tax purposes.

Assets

The tax base of an asset is the value of the asset in the current period for tax purposes. This is either:

- the amount that will be tax deductible in the future against taxable economic benefits when the carrying amount of the asset is recovered; or
- if those economic benefits are not taxable, the tax base is equal to the carrying amount of the asset.

Liabilities

- The tax base of a liability is its carrying amount less any amount that will be tax deductible in the future.
- For revenue received in advance, the tax base of the resulting liability is its carrying amount less any amount of the revenue that will **not** be taxable in future periods.

IAS 12 guidance

IAS 12 states that in the following circumstances, the tax base of an asset or liability will be equal to its carrying amount:

- **Accrued expenses** that have already been deducted in determining an entity's tax liability for the current or earlier periods
- A **loan payable** that is measured at the amount originally received and this amount is the same as the amount repayable on final maturity of the loan
- **Accrued income** that will never be taxable

The table below gives some examples of tax rules and the resulting tax base.

Item	Carrying amount in the statement of financial position	Tax rule	Tax base (amount in 'tax accounts')
Item of PPE	**Carrying amount** = cost – accumulated depreciation	Attracts tax relief in the form of tax depreciation	**Tax written down value** = cost – accumulated tax depreciation
Accrued income	Included in financial statements on an accruals basis ie, when **receivable**	Chargeable for tax on a cash basis, ie when **received**	Nil
		Chargeable for tax on an accruals basis, ie, when **receivable**	Same as carrying amount in statement of financial position
Accrued expenses and provisions	Included in financial statements on an accruals basis ie, when **payable**	Attracts tax relief on a cash basis, ie, when **paid**	Nil
		Attracts tax relief on an accruals basis, ie, when **payable**	Same as carrying amount in statement of financial position
Income received in advance	When the cash is received, it will be included in the financial statements as deferred income ie, a liability	Chargeable for tax on a cash basis, ie, when **received**	Nil (For revenue received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods)

Context example: Tax base 1

Current liabilities include accrued fines and penalties with a carrying amount of £100. These fines and penalties are not deductible for tax purposes.

The tax base of the accrued fines and penalties is £100 (ie, equal to the carrying amount because the amount which will be deducted for tax purposes in a future period is nil). As the tax base equals the statement of financial position carrying amount, there is no temporary difference and no deferred tax implications.

Context example: Tax base 2

Scenario 1 – An entity's current assets include insurance premiums paid in advance of £20,000, for which a tax deduction will be allowed in future periods.

The tax base of the insurance premiums is £20,000, because the whole carrying amount will be deductible for tax purposes in future periods.

Scenario 2 – An entity has recognised a current liability of £400,000 in respect of income received in advance, which will be taxed in future periods.

The tax base of the liability is its £400,000 carrying amount.

Scenario 3 – An entity has recognised a defined benefit liability of £500,000 in respect of a defined benefit retirement plan, but no tax deduction is allowed until contributions are paid into the plan.

The tax base of the liability is nil, because the whole carrying amount will be deductible for tax purposes in future periods.

Scenario 4 – Two years ago, an entity recognised a non-current asset at its £1 million cost. Tax depreciation is allowed on the full cost at 15% per annum on a straight-line basis.

The tax base of the non-current asset is £700,000. 15% of cost has been allowed for tax purposes in each of the two years; the tax base is therefore the 70% of cost which will be deductible for tax purposes in future periods.

Interactive question 1: Tax base

State the tax base of each of the following items.

1.1 Current liabilities include accrued expenses with a carrying amount of £1,000. The related expense will be deducted for tax purposes on a cash basis.

1.2 Current liabilities include interest revenue received in advance, with a carrying amount of £10,000. The related interest revenue was taxed on a cash basis.

1.3 Current assets include prepaid expenses with a carrying amount of £2,000. The related expense has already been deducted for tax purposes.

1.4 A loan payable has a carrying amount of £1 million. The repayment of the loan will have no tax consequences.

See **Answer** at the end of this chapter.

3.2 Types of temporary difference

IAS 12 makes a distinction between two types of temporary difference:

(a) Taxable temporary differences

(b) Deductible temporary differences

3.2.1 Taxable temporary differences

- Taxable temporary differences arise where the carrying amount exceeds the tax base.
- They result in a deferred tax liability.

Definitions

Taxable temporary differences: Temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

Deferred tax liabilities: The amounts of income taxes payable in future periods in respect of taxable temporary differences.

Context example: Temporary differences 2

Scenario 1 – An entity recognised a non-current asset at its £1 million cost two years ago. Tax depreciation is allowed on the full cost at 15% per annum straight line, while accounting depreciation is at 10% per annum straight line.

The tax base of the non-current asset is £700,000, but the carrying amount is £800,000. The taxable temporary difference is therefore the difference of £100,000.

Scenario 2 – An entity has issued £400,000 of debt redeemable in five years, incurring £20,000 of issue expenses. The issue expenses have been deducted from the liability and are being amortised over the five-year life of the debt. To date, £5,000 has been amortised, but the whole £20,000 has been allowed as a tax deduction.

The tax base of the liability is its £400,000 carrying amount less the £nil amount which is deductible for tax purposes in future periods. The carrying amount is £385,000 and the taxable temporary difference is therefore the difference of £15,000.

3.2.2 Deductible temporary differences

- Deductible temporary differences arise where the tax base exceeds the carrying amount.
- These result in a deferred tax asset.

Definitions

Deductible temporary differences: Temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

Deferred tax assets: The amounts of income taxes recoverable in future periods in respect of:

- deductible temporary differences; and
- the carry forward of unused tax losses/unused tax credits.

Context example: Temporary differences 3

A factory was purchased for £4 million and has been given cumulative capital allowances of £1 million. It therefore has a tax base of £3 million.

Assumption 1	If the carrying amount of the factory in the statement of financial position is £3.5 million, then there is a taxable temporary difference of £500,000. (**Note:** Where capital allowances claimed are cumulatively greater than accounting depreciation, this is sometimes referred to as 'accelerated' as the tax allowances have been awarded sooner than accounting depreciation has been recognised.)
Assumption 2	If, instead, the carrying amount of the factory in the statement of financial position is £2 million, then there is a deductible temporary difference of £1 million.

3.2.3 Summary diagram

The following diagram may help you remember the distinction:

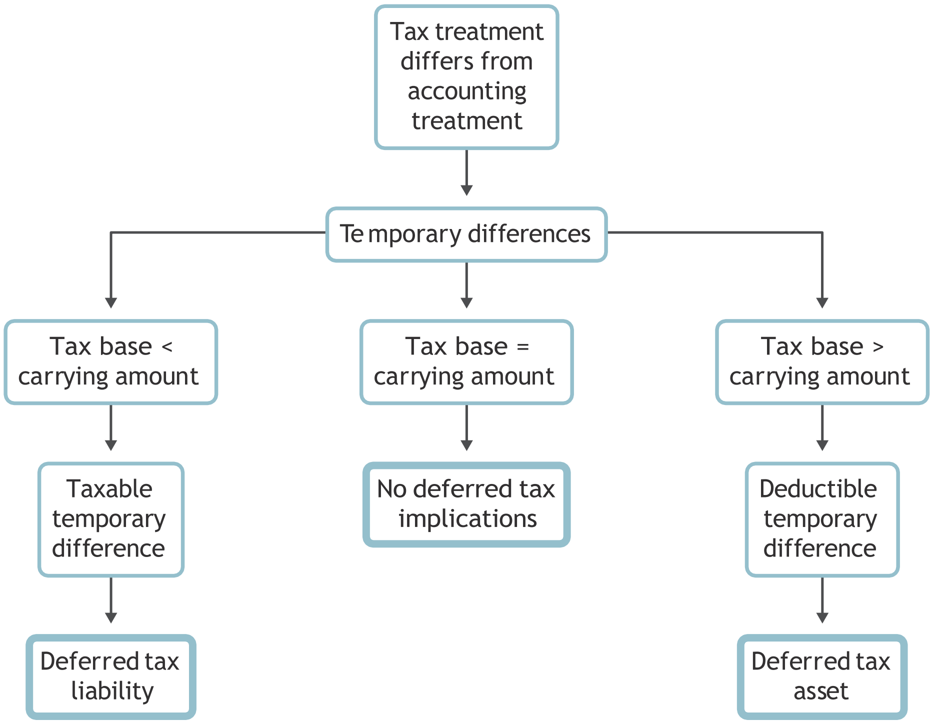


Figure 22.1: Temporary differences

3.3 Temporary differences with no deferred tax impact

A deferred tax liability or asset should be recognised for all taxable and deductible temporary differences unless they arise from:

- the initial recognition of goodwill; or
- the initial recognition of an asset or liability in a transaction which:
- is not a business combination; and
- at the time of the transaction, affects neither accounting nor taxable profit.

Examples of initial recognition of assets or liabilities with no deferred tax effect

Examples of initial recognition of assets or liabilities in a transaction which does not affect either accounting or taxable profit at the time of the transaction are:

(a) An intangible asset with a finite life which attracts no tax allowances. In this case, taxable profit is never affected, and amortisation is only charged to accounting profit after the transaction.

(b) A non-taxable government grant related to an asset which is deducted in arriving at the carrying amount of the asset. For tax purposes it is not deducted from the tax base.

Although a deductible temporary difference arises in both cases (on initial recognition in the second case, and subsequently in the first case), this is not permitted to be recognised as a deferred tax asset, as it would make the financial statements less transparent. The first of the two cases, an intangible asset with a finite life which attracts no tax allowances, only gives rise to a deferred tax asset if it has a chargeable gains cost. If it was acquired on consolidation, no deferred tax asset arises as the amortisation of the intangible just decreases consolidated retained earnings.

Worked example: Initial recognition

As another example of the principles behind initial recognition, suppose Petros Co intends to use an asset which cost £10,000 in 20X7 throughout its useful life of five years. Its residual value would then be nil. The tax rate is 40%. Any capital gain on disposal would not be taxable (and any capital loss not deductible). Depreciation of the asset is not deductible for tax purposes.

Requirement

State the deferred tax consequences in each of the years 20X7 and 20X8.

Solution 20X7

To recover the carrying amount of the asset, Petros will earn taxable income of £10,000 and pay tax
of £4,000. The resulting deferred tax liability of £4,000 would not be recognised because it results from the initial recognition of the asset.

20X8

The carrying value of the asset is now £8,000. In earning taxable income of £8,000, Petros will pay tax of £3,200. Again, the resulting deferred tax liability of £3,200 is not recognised, because it results from the initial recognition of the asset.

3.4 Summary

The following diagram summarises the calculation and types of temporary difference:

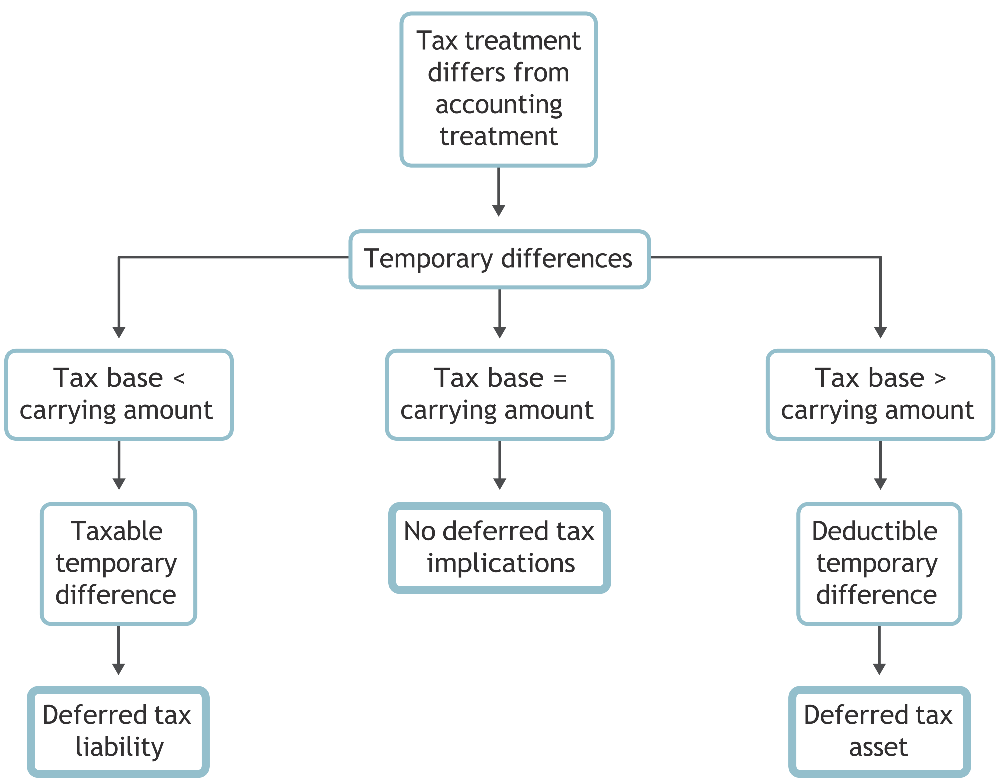


Figure 22.2: The calculation and types of temporary difference

Context example: Tax base of assets

(a) A machine cost £100,000. For tax purposes, capital allowances of £30,000 have already been deducted in the current and prior periods; and the remaining cost will be deductible in future periods. Assume that revenue generated by using the machine is taxable, any gain on disposal of the machine will be taxable and any loss on disposal will be deductible for tax purposes. The carrying amount of the machine for accounting purposes is £82,000.

The tax base of the machine is £70,000 as this remains to be deducted in future periods. There is a taxable temporary difference of £12,000 (ie, £82,000 – £70,000).

(b) Interest receivable has a carrying amount of £1,000. The related interest revenue will be taxed on a cash basis.

The tax base of the interest receivable is nil, as the accrual is not recognised for tax purposes. There is therefore a taxable temporary difference of £1,000.

(c) Trade receivables have a carrying amount of £10,000. Assume that the related revenue has already been included in taxable profit.

The tax base of the trade receivables is £10,000. (**Note:** The difference between this case and the previous example is that in this case the amount has been included in both the accounting profit and the taxable profit for the period, thus there is no future taxable impact.) As the tax base equals the carrying amount, there is no temporary difference and no deferred tax.

(d) A loan receivable has a carrying amount of £8,000. The repayment of the loan will have no tax consequences.

The tax base of the loan is £8,000, as there are no future tax consequences. Thus, as the tax base equals the carrying value, there is no temporary difference and no deferred tax.

Worked example: Tax base of liabilities

In the following cases show and explain:

(1) the tax base

(2) temporary differences:

Requirements

1 Current liabilities include accrued expenses with a carrying amount of £2,000. The related expense will be deducted for tax purposes on a cash basis.

2 Current liabilities include accrued expenses with a carrying amount of £3,000. The related expense has already been deducted for tax purposes.

3 A loan payable has a carrying amount of £5,000. The repayment of the loan will have no tax consequences.

4 Current liabilities include interest revenue received in advance, with a carrying amount of £7,000. The related interest revenue was taxed on a cash basis.

Solution

1 The tax base of the accrued expenses is nil. This is because the expenses have been recognised in accounting profit, but the tax impact is yet to take effect. There is therefore a deductible temporary difference of £2,000.

2 The tax base of the accrued expenses is £3,000, ie, the carrying value (£3,000) less the amount which will be deducted for tax purposes in future periods (nil, as relief has already been obtained). There is no temporary difference, and no deferred tax arises.

3 The tax base of the loan is £5,000, as there are no future tax consequences. Thus, as the tax base equals the carrying value, there is no temporary difference and no deferred tax.

4 The tax base of the interest received in advance is nil (ie, the carrying value (£7,000) less the amount which will not be taxable in future periods (£7,000, as it has all been charged already). As a result there is a deductible temporary difference of £7,000.

4 Measurement of deferred tax assets and liabilities

Section overview

The tax rate is applied to temporary differences in order to calculate the deferred tax asset or liability. The tax rate should be applied to temporary differences in order to calculate deferred tax:

- Taxable temporary differences × tax rate = deferred tax liability
- Deductible temporary differences × tax rate = deferred tax asset

Worked example: Calculation of deferred tax

A company purchased an asset costing £1,500. At the end of 20X8 the carrying amount is £1,000. The cumulative capital allowances are £900 and the current tax rate is 25%.

Requirement

Calculate the deferred tax liability for the asset.

Solution

The tax base of the asset is £1,500 – £900 = £600.

The carrying amount exceeds the tax base and therefore there is a taxable temporary difference of £1,000 – £600 = £400. The entity must therefore recognise a deferred tax liability of £400 × 25% = £100.

(In order to recover the carrying amount of £1,000, the entity must earn taxable income of £1,000, but it will only be able to deduct £600 as a taxable expense. The entity must therefore pay income tax of £400 × 25% = £100 when the carrying amount of the asset is recovered.)

4.1 Tax rate

The tax rates that should be used to calculate deferred tax are the ones that are expected to apply in the period when the asset is realised or the liability settled. The best estimate of this tax rate is the rate which has been enacted or substantively enacted by the reporting date.

For example, in the Summer Budget of 2015, the government announced legislation setting the Corporation Tax main rate (for all profits except ring fence profits) at 19% for the years starting on 1 April 2017, 2018 and 2019 and at 18% for the year starting 1 April 2020.

Note: The tax rates used in this chapter are assumptions or hypothetical rates rather than real rates.

Worked example: Tax rate

A Muldovian company enters into a long-term contract to build a motorway in that country. During the year ended 31 December 20X3, the entity recognises £4 million of income on this contract even though it is not expected to receive the related cash until the year ending 31 December 20X5.

Under the tax rules of Muldovia, companies are charged tax on a cash receipts basis.

The tax rate for companies in Muldovia was 30% in the year to 31 December 20X3, but their government has voted in favour of a reduction to 29% in 20X4. There is currently discussion of the rate dropping to 28% in 20X5, but as yet there is no agreement.

Requirement

What rate of tax should be used to determine the deferred tax balance?

Solution

A rate of 29% should be used. The rate is that expected to apply when the asset is realised, thus the rate of 30% in 20X3, when the temporary difference originated, is not relevant. The 28% would be used if it had been enacted or substantively enacted, but it is only under discussion. Thus, our best estimate of the rate applying in 20X5, based on laws already enacted or substantively enacted, is the rate for 20X4 (ie, the previous year) of 29%.

4.1.1 Progressive rates of tax

In some countries, different tax rates apply to different levels of taxable income. In this case, an **average rate** expected to apply to the taxable profit of the entity in the period in which the temporary difference is expected to reverse should be identified and used to calculate the temporary difference.

4.1.2 Different rates of tax

Some countries also apply different rates of tax to different types of income eg, one rate to profits and another to gains.

Where this is the case, the tax rate used to calculate the deferred tax amount should reflect the manner in which the entity expects to recover the carrying amount of assets or settle the carrying amount of liabilities.

Worked example: Manner of recovery/settlement

Richcard Co has an asset with a carrying amount of £10,000 and a tax base of £6,000. If the asset were sold, a tax rate of 20% would apply. A tax rate of 30% would apply to other income.

Requirements

State the deferred tax consequences making the following alternative assumptions:

(a) The entity sells the asset without further use

(b) The entity expects to retain the asset and recover its carrying amount through use

Solution

(a) A deferred tax liability is recognised of £(10,000 – 6,000) × 20% = £800.

(b) A deferred tax liability is recognised of £(10,000 – 6,000) × 30% = £1,200.

Interactive question 2: Recovery 1

Emida Co has an asset which cost £100,000. In 20X9 the carrying amount was £80,000 and the asset was revalued to £150,000. No equivalent adjustment was made for tax purposes. Cumulative depreciation for tax purposes is £30,000 and the tax rate is 30%. If the asset is sold for more than cost, the cumulative tax depreciation of £30,000 will be included in taxable income but sale proceeds in excess of cost will not be taxable.

Requirements

State the deferred tax consequences of the above, making the following alternative assumptions:

(a) The entity expects to recover the carrying amount through continued use of the asset.

(b) The entity expects to recover the carrying amount of the asset through sale.

See **Answer** at the end of this chapter.

The manner of recovery may also affect the tax base of an asset or liability. Tax base should be measured according to the expected manner of recovery or settlement.

Interactive question 3: Recovery 2

The facts are as in Recovery 1 above except that, if the asset is sold for more than cost, the cumulative tax depreciation will be included in taxable income (taxed at 30%) and the sale proceeds will be taxed at 40% after deducting an inflation-adjusted cost of £110,000.

Requirements

State the deferred tax consequences of the above, making the following alternative assumptions:

(a) The entity expects to recover the carrying amount through continued use of the asset.

(b) The entity expects to recover the carrying amount of the asset through sale.

See **Answer** at the end of this chapter.

Professional skills focus: Applying judgement

Judgement must be applied in the assumptions made about the manner of recovery or settlement. With deferred tax assets, judgement must be exercised in determining whether an entity will earn sufficient taxable profits in future periods to benefit from a reduction in tax payments.

4.2 Discounting

IAS 12 states that deferred tax assets and liabilities **should not be discounted** because the complexities and difficulties involved will affect reliability. Discounting would require detailed scheduling of the timing of the reversal of each temporary difference, but this is often impracticable. If discounting were permitted, this would affect comparability.

Note, however, that where carrying amounts of assets or liabilities are discounted (eg, a pension obligation), the temporary difference is determined based on a discounted value.

5 Recognition of deferred tax in the financial statements

Section overview

The deferred tax amount calculated is recorded as a deferred tax balance in the statement of financial position with a corresponding entry to the tax charge, other comprehensive income or goodwill.

5.1 Principles of recognition

As with current tax, deferred tax should normally be recognised as income or an expense amount within the tax charge, and included in the net profit or loss for the period. Only the movement in the deferred tax asset/liability on the statement of financial position is recorded:

DEBIT	Tax charge	X	
CREDIT	Deferred tax liability		X
or			
DEBIT	Deferred tax asset	X	
CREDIT	Tax charge		X

Note that the recognition of a deferred tax asset may be restricted (see next section).

Worked example: Deferred tax in the financial statements

An entity purchases a machine for £64,000 at the beginning of the year to 31 December 20X1. It has a useful life of five years, and on 31 December 20X5 the asset is disposed of at a zero residual value. The entity uses straight-line depreciation. The accounting year end is 31 December.

Assume that the machine qualifies for capital allowances, at a rate of 20% per annum on a reducing balance basis.

Assume that the rate of tax is 30%.

Requirement

Show the deferred tax balance in the statement of financial position and the deferred tax charge for each year of the asset's life.

Solution

Deferred tax

	20X1	20X2	20X3	20X4	20X5
	£	£	£	£	£
Carrying amount	51,200	38,400	25,600	12,800	0
Tax base	51,200	40,960	32,768	26,214	0
Taxable/(deductible) temporary difference	0	(2,560)	(7,168)	(13,414)	0

	20X1	20X2	20X3	20X4	20X5
	£	£	£	£	£
Opening deferred tax liability/(asset)	0	0	(768)	(2,150)	(4,024)
Deferred tax expense/(credit)	0	(768)	(1,382)	(1,874)	4,024
Closing deferred tax liability/(asset)	0	(768)	(2,150)	(4,024)	0

5.1.1 Exceptions to recognition in profit or loss

(a) Deferred tax relating to items dealt with as **other comprehensive income** (such as a revaluation) should be recognised as tax relating to other comprehensive income within the statement of profit or loss and other comprehensive income.

(b) Deferred tax relating to items dealt with **directly in equity** (such as the correction of an error or retrospective application of a change in accounting policy) should also be recognised directly in equity.

(c) Deferred tax resulting from a business combination is included in the initial cost of **goodwill** (this is covered in more detail later in the chapter).

Where it is not possible to determine the amount of current/deferred tax that relates to other comprehensive income and items credited/charged to equity, such tax amounts should be based on a reasonable **pro-rata allocation** of the entity's current/deferred tax.

5.1.2 Components of deferred tax

Deferred tax charges will consist of **two components**:

(a) Deferred tax relating to **temporary differences**

(b) Adjustments relating to **changes in the carrying amount of deferred tax assets/liabilities** (where there is no change in temporary differences) eg, changes in tax rates/laws, reassessment of the recoverability of deferred tax assets, or a change in the expected recovery of an asset

5.2 Deferred tax assets

A deferred tax asset must satisfy the recognition criteria given in IAS 12. These state that a deferred tax asset should only be recognised to the extent that it is probable that taxable profit will be available against which it can be used.

This is an application of prudence.

Worked example: Recognition of deferred tax asset

Pargatha Co recognises a liability of £10,000 for accrued product warranty costs on 31 December 20X7. Assume that these product warranty costs will not be deductible for tax purposes until the entity pays claims. The tax rate is 25%.

Requirement

State the deferred tax implications of this situation.

Solution

The carrying amount of the liability is (£10,000).

The tax base of the liability is nil (carrying amount of £10,000 less the amount that will be deductible for tax purposes in respect of the liability in future periods).

When the liability is settled for its carrying amount, the entity's future taxable profit will be reduced by £10,000 and so its future tax payments by £10,000 × 25% = £2,500.

The carrying amount of (£10,000) is less than the tax base of nil and therefore the difference of £10,000 is a deductible temporary difference.

The entity should therefore recognise a deferred tax asset of £10,000 × 25% = £2,500 provided that it is probable that the entity will earn sufficient taxable profits in future periods to benefit from a reduction in tax payments.

5.2.1 Future taxable profits

When can we be sure that sufficient taxable profit will be available, against which a deductible temporary difference can be used?

IAS 12 states that this is assumed when:

- there are sufficient taxable temporary differences;
- the taxable and deductible temporary differences relate to the same entity and same tax authority;
- the taxable temporary differences are expected to reverse either:
- in the same period as the deductible temporary differences; or
- in periods in which a tax loss arising from the deferred tax asset can be used.

Insufficient taxable temporary differences

Where there are insufficient taxable temporary differences, a deferred tax asset may only be recognised to the extent that:

(a) it is probable that taxable profits will be sufficient in the same period as the reversal of the deductible temporary difference (ignoring taxable amounts arising from future deductible temporary differences); and

(b) tax planning opportunities exist that will allow the entity to create taxable profit in the appropriate periods.

If an entity has a history of recent losses, then this is evidence that future taxable profit may not be available.

5.2.2 Reassessment of unrecognised deferred tax assets

For all unrecognised deferred tax assets, at each reporting date an entity should reassess the availability of future taxable profits and whether part or all of any unrecognised deferred tax assets should now be recognised. This may be due to an improvement in trading conditions which is expected to continue.

6 Common scenarios

Section overview

There are a number of common examples which result in a taxable or deductible temporary difference. However, this list is not exhaustive.

6.1 Taxable temporary differences

6.1.1 Accelerated capital allowances

- These arise when capital allowances for tax purposes are received before deductions for accounting depreciation are recognised in the statement of financial position (accelerated capital allowances).
- The temporary difference is the difference between the carrying amount of the asset at the reporting date and its tax written-down value (tax base).
- The resulting deferred tax is recognised in profit or loss.

Interactive question 4: Initial recognition

Jonquil Co buys equipment for £50,000 at the start of 20X1 and depreciates it on a straight-line basis over its expected useful life of five years. For tax purposes, the equipment is depreciated at 25% per annum on a straight-line basis. Tax losses may be carried back against the taxable profit of the previous five years. In 20X0, the entity's taxable profit was £25,000. The tax rate is 40%.

Requirement

Assuming nil profits/losses after depreciation in years 20X1 to 20X5, show the current and deferred tax impact in years 20X1 to 20X5 of the acquisition of the equipment.

See **Answer** at the end of this chapter.

6.1.2 Interest revenue

Please note the following key points.

- In some jurisdictions, interest revenue may be included in profit or loss on an accruals basis, but taxed when received.
- The temporary difference is equivalent to the income accrual at the reporting date, as the tax base of the interest receivable is nil.
- The resulting deferred tax is recognised in profit or loss.

6.1.3 Development costs

- Development costs may be capitalised for accounting purposes in accordance with IAS 38 while being deducted from taxable profit in the period incurred (ie, they receive immediate tax relief).
- The temporary difference is equivalent to the amount capitalised at the reporting date, as the tax base of the costs is nil since they have already been deducted from taxable profits.
- The resulting deferred tax is recognised in profit or loss.

6.1.4 Revaluations to fair value – property, plant and equipment

IFRS permits or requires some assets to be revalued to fair value, eg, property, plant and equipment under IAS 16, *Property, Plant and Equipment*.

Temporary difference

In some jurisdictions a revaluation will affect taxable profit in the current period. In this case, no temporary difference arises, as both carrying value and the tax base are adjusted.

In other jurisdictions, the revaluation does not affect taxable profits in the period of revaluation and consequently, the tax base of the asset is not adjusted. Hence a temporary difference arises.

This should be provided for in full based on the difference between carrying amount and tax base. An upward revaluation will therefore give rise to a deferred tax liability, even if:

- the entity does not intend to dispose of the asset; or
- tax due on any future gain can be deferred through rollover relief.

This is because the revalued amount will be recovered through use which will generate taxable income in excess of the depreciation allowable for tax purposes in future periods.

Manner of recovery

The carrying amount of a revalued asset may be recovered:

- through sale
- through continued use

The manner of recovery may affect the tax rate applicable to the temporary difference and/or the tax base of the asset. Interactive questions 2 and 3 of this chapter provide illustrations of this.

Recording deferred tax

As the underlying revaluation is recognised as other comprehensive income, so the deferred tax thereon is also recognised as part of tax relating to other comprehensive income. The accounting entry is therefore:

DEBIT	Tax on other comprehensive income	X	
CREDIT	Deferred tax liability		X

Non-depreciated revalued assets

SIC 21, *Income Taxes – Recovery of Revalued Non-Depreciable Assets* requires that deferred tax should be recognised even where non-current assets are not depreciated (eg, land). This is because the carrying value will ultimately be recovered on disposal.

Worked example: Revaluation

A building in the UK was acquired on 1 January 20X2 at a cost of £500,000. It has been depreciated at a rate of 2% straight line and has also attracted tax allowances at a rate of 4% straight line. On 31 December 20X6, the building is revalued to £650,000. The tax rate is 30%.

Requirement

What are the deferred tax implications of the revaluation?

Solution

Implications:

- The carrying amount of the building before the revaluation was £500,000 – (5 × 2% × £500,000) = £450,000.
- The tax base of the building before the revaluation was £500,000 – (5 × 4% × £500,000) = £400,000.
- The temporary difference of £50,000 would have resulted in a deferred tax liability of 30% × £50,000 = £15,000.
- As a result of the revaluation, the carrying amount of the building is increased to £650,000.
- The tax base does not change.

- The temporary difference therefore increases to £250,000 (£650,000 – £400,000), resulting in a total deferred tax liability of 30% × £250,000 = £75,000.
- As a result of the revaluation, additional deferred tax of £60,000 must therefore be recognised.
- This could also be calculated by applying the tax rate to the difference between carrying amount of £450,000 and valuation of £650,000.

6.1.5 Revaluations to fair value – other assets

IFRS Standards permit or require certain other assets to be revalued to fair value, for example:

- Certain financial instruments under IFRS 9, *Financial Instruments*
- Investment properties under IAS 40, *Investment Property*

Where the revaluation is recognised in **profit or loss** (eg, fair value through profit or loss instruments, investment properties) and the amount is taxable/allowable for tax, then no deferred tax arises as both the carrying value and the tax base are adjusted.

Where the revaluation is recognised as **other comprehensive income** (eg, many investments in equity instruments) and does not therefore impact taxable profits, then the tax base of the asset is not adjusted and deferred tax arises. This deferred tax is also recognised as other comprehensive income.

6.1.6 Retirement benefit costs

In the financial statements, retirement benefit costs are **deducted from accounting profit** as the service is provided by the employee. They are **not deducted in determining taxable profit** until the entity pays either retirement benefits or contributions to a fund. Thus a temporary difference may arise.

(a) A **deductible temporary difference** arises between the carrying amount of the net defined benefit liability and its tax base. The tax base is usually nil.

(b) The deductible temporary difference will normally **reverse**.

(c) A **deferred tax asset** is recognised for this temporary difference to the extent that it is recoverable; that is, sufficient profit will be available against which the deductible temporary difference can be used.

(d) If there is a net defined benefit asset, for example when there is a surplus in the pension plan, a **taxable temporary difference** arises and a **deferred tax liability** is recognised.

Under IAS 12, both current and deferred tax must be recognised outside profit or loss if the tax relates to items that are recognised outside profit or loss. This could make things complicated as it interacts with IAS 19, *Employee Benefits.*

IAS 19 requires recognition of remeasurement (actuarial) gains and losses in other comprehensive income in the period in which they occur.

It may be difficult to determine the amount of current and deferred tax that relates to items recognised in profit or loss or in other comprehensive income. As an approximation, current and deferred tax are allocated on an **appropriate basis**, often pro rata.

Context example: Defined benefit asset with a remeasurement loss

	Defined benefit asset £'000	Current tax relief (28%) £'000	Deferred tax liability (28%) £'000
Brought forward	1,000	–	(280)
Contributions	600	(168)	
Profit or loss: net pension cost	(500)	140	–
OCI: actuarial loss	(200)	28	28
	(700)	168	28
Carried forward	900	–	252

Context example: Defined benefit liability with a remeasurement loss

	Defined benefit liability £'000	Current tax relief (28%) £'000	Deferred tax asset (28%) £'000
Brought forward	(2,000)	–	560
Contributions	1,200	(336)	–
Profit or loss: net pension cost	(1,000)	280	–
OCI: actuarial loss	(400)	56	56
	(1,400)	336	56
Carried forward	(2,200)	–	616

Worked example: Deferred tax and retirement benefits

Note: Look back to Chapter 18 on employee benefits to refresh your memory of how to account for pensions. In this example we look at how employee benefits and deferred tax interact.

Operating expenses in the draft accounts for Celia include £405,000 relating to the company's defined benefit pension scheme. This figure represents the contributions paid into the scheme in the year. No other entries have been made relating to this scheme. The figures included on the draft statement of financial position represent opening balances as at 1 October 20X5:

	£
Pension scheme assets	2,160,000
Pension scheme liabilities	(2,530,000)
	(370,000)
Deferred tax asset	111,000
	(259,000)

CHAPTER 22

After the year end, a report was obtained from an independent actuary. This gave valuations as at 30 September 20X6 of:

	£
Pension scheme assets	2,090,200
Pension scheme liabilities	(2,625,000)

Other information in the report included:

Yield on high-quality corporate bonds	10%
Current service cost	£374,000
Payment out of scheme relating to employees transferring out	£400,000
Reduction in liability relating to transfers	£350,000
Pensions paid	£220,000

All receipts and payments into and out of the scheme can be assumed to have occurred on 30 September 20X6.

Celia recognises any gains and losses on remeasurement of defined benefit pension plans directly in other comprehensive income in accordance with IAS 19.

In the tax regime in which Celia operates, a tax deduction is allowed on payment of pension contributions. No tax deduction is allowed for benefits paid. Assume that the rate of tax applicable to 20X5, 20X6 and announced for 20X7 is 30%.

Requirements

1 Explain how each of the above transactions should be treated in the financial statements for the year ended 30 September 20X6.

2 Prepare an extract from the statement of profit or loss and other comprehensive income showing other comprehensive income for the year ended 30 September 20X6.

Solution

1 **Pensions**

The contributions paid have been charged to profit or loss in contravention of IAS 19, *Employee Benefits*.

Under IAS 19, the following must be done:

- Actuarial valuations of assets and liabilities revised at the year end
- All gains and losses recognised

In profit or loss	Current service cost Transfers Net interest on net defined benefit liability
In other comprehensive income	Remeasurement gains and losses

Deferred tax must also be recognised. Tax deductions are allowed on pension contributions. IAS 12, *Income Taxes* requires deferred tax relating to items charged or credited to other comprehensive income (OCI) to be recognised in other comprehensive income hence the amount of the deferred tax movement relating to the losses on remeasurement charged directly to OCI must be split out and credited directly to OCI.

2 Amounts recognised in other comprehensive income (extract)

	£
Actuarial loss on defined benefit obligation (W1)	(38,000)
Return on plan assets (excluding amounts in net interest) (W1)	(70,800)
	(108,800)
Deferred tax credit relating to actuarial losses on defined benefit plan (W2)	32,640
Other comprehensive income for the year	(76,160)

WORKINGS

(1) **Pension scheme**

	Pension scheme assets £	**Pension scheme liabilities £**
At 1 October 20X5	2,160,000	2,530,000
Interest cost on obligation (10% × 2,530,000)		253,000
Interest on plan assets (10% × 2,160,000)	216,000	
Current service cost		374,000
Contributions	405,000	
Transfers	(400,000)	(350,000)
Pensions paid	(220,000)	(220,000)
Loss on remeasurement recognised in OCI	(70,800)	38,000
At 30 September 20X6	2,090,200	2,625,000

(2) **Deferred tax on pension liability**

	£	**Current tax (P/L) £**	**OCI £**	**Deferred tax asset £**	**Note**
Net pension liability at 30 September 20X6 (2,530,000 –2,160,000)	370,000			111,000	
Contribution	(405,000)	Cr (121,500)		(121,500)	1
Profit and loss debits service cost 374,000 + interest costs 37,000	411,000	Dr 123,300		123,300	1
Transfers (400,000 – 350,000)	50,000	Dr 15,000		15,000	3
Loss on remeasurement to OCI	108,800		32,640	32,640	
Profit or loss/OCI movement		**16,800**	**32,640**	**49,440**	
Net pension liability/ deferred tax asset at 30 September 20X6	534,800			160,440	

Notes

1 Tax relief now given in the current tax charge, so it makes sense for this element of the movement to be in profit or loss

2 Also makes sense that the costs results increase in the deferred tax asset so this should go to profit or loss too

3 Because the liability increases the deferred tax asset increases

6.2 Deductible temporary differences

6.2.1 Tax losses

Where tax losses arise, for example as trading losses or non-trading loan relationship deficits, then the manner of recognition of these in the financial statements depends on how they are expected to be used.

(a) If losses are **carried back** to crystallise a refund, then a receivable is recorded in the statement of financial position and the corresponding credit is to the current tax charge.

(b) If losses are **carried forward** to be used against future profits or gains, then they should be recognised as deferred tax assets to the extent that it is probable that future taxable profit will be available against which the losses can be used.

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

Recognition of deferred tax asset

The existence of **unused tax losses** is strong evidence that future taxable profit may not be available. The following should be considered before recognising any deferred tax asset:

- Whether an entity has sufficient taxable temporary differences against which the unused tax losses can be offset
- Whether it is probable that the entity will have taxable profits before the unused tax losses expire
- Whether the tax losses result from identifiable causes which are unlikely to recur
- Whether tax planning opportunities are available to create taxable profit

Group tax relief

Where the acquisition of a subsidiary means that tax losses which previously could not be used can now be used against the profits of the subsidiary, a deferred tax asset may be recognised in the financial statements of the parent company. This amount is **not** taken into account in calculating goodwill arising on acquisition.

6.2.2 Provisions

- A provision is recognised for accounting purposes when there is a present obligation, but it is not deductible for tax purposes until the expenditure is incurred.
- In this case, the temporary difference is equal to the amount of the provision, since the tax base is nil.
- Deferred tax is recognised in profit or loss.

6.2.3 Share-based payments

Share-based transactions may be tax deductible in some jurisdictions. However, the amount deductible for tax purposes does not always correspond to the amount that is charged to profit or loss under IFRS 2.

In most cases it is not just the amount but also the timing of the expense allowable for tax purposes that will differ from that required by IFRS 2.

For example, an entity recognises an expense for share options granted under IFRS 2, but does not receive a tax deduction until the options are exercised. The tax deduction will be based on the share price on the exercise date and will be measured on the basis of the options' intrinsic value ie, the difference between market price and exercise price at the exercise date. In the case of share-based employee benefits under IFRS 2, the cost of the services as reflected in the financial statements is expensed and therefore the carrying amount is nil.

The difference between the carrying amount of nil and the tax base of share-based payment expense received to date is a deferred tax asset, provided the entity has sufficient future taxable profits to use this deferred tax asset.

The deferred tax asset temporary difference is measured as:

	£
Carrying amount of share-based payment expense	0
Less tax base of share-based payment expense(X) (estimated amount tax authorities will permit as a deduction in future periods, based on year-end information)	
Temporary difference	(X)
Deferred tax asset at X%	X

If the amount of the tax deduction (or estimated future tax deduction) exceeds the amount of the related cumulative remuneration expense, this indicates that the tax deduction also relates to an equity item.

The excess is therefore recognised directly in equity. The diagrams below show the accounting for equity-settled and cash-settled transactions.

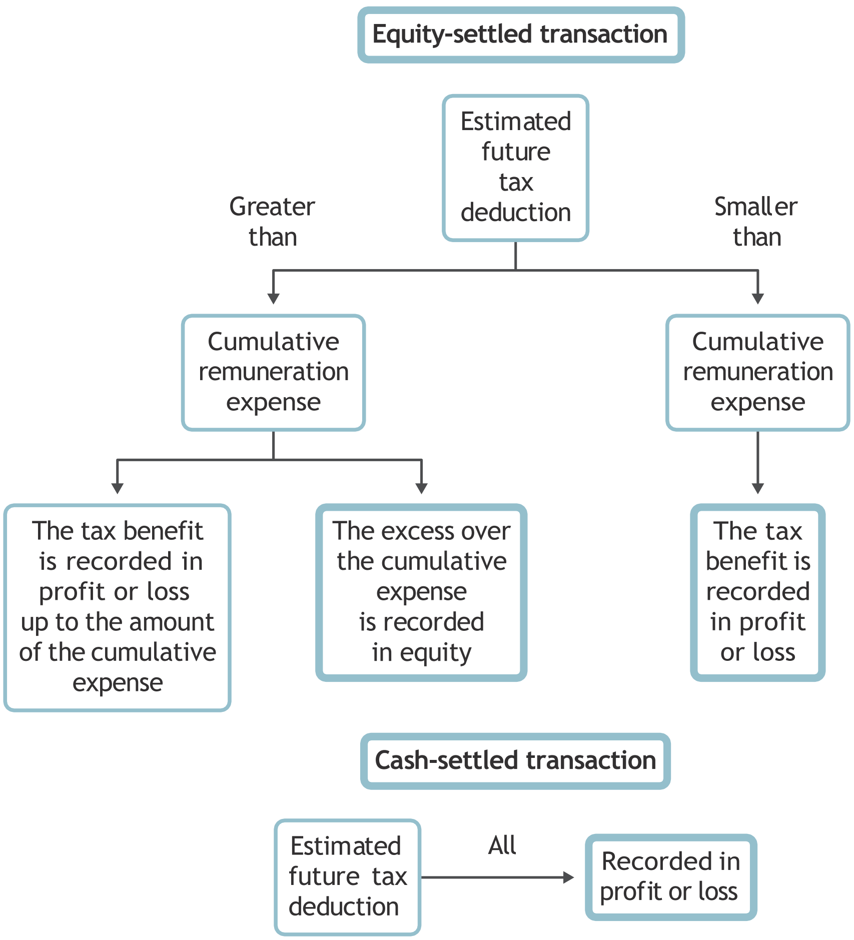


Figure 22.3: Accounting for equity-settled and cash-settled transactions

CHAPTER 22

Worked example: Deferred tax

On 1 January 20X2, an entity granted 5,000 share options to an employee vesting two years later on 31 December 20X3. The fair value of each option measured at the grant date was £3.

Tax law in the jurisdiction in which the entity operates allows a tax deduction of the intrinsic value of the options on exercise. The intrinsic value of the share options was £1.20 at 31 December 20X2 and
£3.40 at 31 December 20X3, on which date the options were exercised. Assume a tax rate of 30%.

Requirement

Show the deferred tax accounting treatment of the above transaction at 31 December 20X2, 31 December 20X3 (before exercise), and on exercise.

Solution

Deferred tax

	31 Dec 20X2	**31 Dec 20X3 before exercise**
	£	**£**
Carrying amount of share-based payment expense	0	0
Less tax base of share-based payment expense	(3,000)	(17,000)
(5,000 × £1.2 ÷ 2)/(5,000 × £3.40)		
Temporary difference	(3,000)	(17,000)
Deferred tax asset @ 30%	900	5,100
Deferred tax (Cr profit) (5,100 – 900 – (Working) 600)	900	3,600
Deferred tax (Cr Equity) (Working)	0	600

On exercise, the deferred tax asset is replaced by a current tax asset.

The double entry is:			**£**	
DEBIT	deferred tax (profit)	4,500		reversal
DEBIT	deferred tax (equity)	600		reversal
CREDIT	deferred tax asset		5,100	reversal
DEBIT	current tax asset			
CREDIT	current tax (profit)	5,100	4,500	
CREDIT	current tax (equity)		600	

WORKING

	£	£
Accounting expense recognised (5,000 × £3 ÷ 2)/(5,000 × £3)	7,500	15,000
Tax deduction	(3,000)	(17,000)
Excess temporary difference	0	(2,000)
Excess deferred tax asset to equity @ 30%	0	600

Interactive question 5: Share option scheme and deferred tax

Frost plc has the following share option scheme at 31 May 20X7:

Director's name	Grant date	Options granted	Fair value of options at grant date	Exercise price	Vesting date
			£		
Edmund Houston	1 June 20X5	40,000	3.00	4.00	6/20X7
Kieran Bullen	1 June 20X6	120,000	2.50	5.00	6/20X9

The price of the company's shares at 31 May 20X7 is £8 per share and at 31 May 20X6 was £8.50 per share.

The directors must be working for Frost on the vesting date in order for the options to vest.

No directors have left the company since the issue of the share options and none are expected to leave before June 20X9. The shares can be exercised on the first day of the month in which they vest.

In accordance with IFRS 2 an expense of £60,000 has been charged to profits in the year ended 31 May 20X6 in respect of the share option scheme. The cumulative expense for the two years ended 31 May 20X7 is £220,000.

Tax allowances arise when the options are exercised and the tax allowance is based on the option's intrinsic value at the exercise date.

Assume a tax rate of 30%.

Requirement

What are the deferred tax implications of the share option scheme?

See **Answer** at the end of this chapter.

6.2.4 Recognition of deferred tax assets for unrealised losses

This amendment was issued in January 2016 in order to clarify when a deferred tax asset should be recognised for unrealised losses. For example, an entity holds a debt instrument that is falling in value, without a corresponding tax deduction, but the entity knows that it will receive the full nominal amount on the due date, and there will be no tax consequences of that repayment. The question arises of whether to recognise a deferred tax asset on this unrealised loss.

The IASB clarified **that unrealised losses on debt instruments measured at fair value and measured at cost for tax purposes give rise to a deductible temporary difference** regardless of whether the debt instrument's holder expects to recover the carrying amount of the debt instrument by sale or by use.

This may seem to contradict the key requirement that an entity recognises deferred tax assets only if it is probable that it will have future taxable profits. However, the amendment also addresses the issue of what constitutes future taxable profits, and clarifies the following:

(a) The carrying amount of an asset does not limit the estimation of probable future taxable profits.

(b) Estimates for future taxable profits exclude tax deductions resulting from the reversal of deductible temporary differences.

(c) An entity assesses a deferred tax asset in combination with other deferred tax assets. Where tax law restricts the utilisation of tax losses, an entity would assess a deferred tax asset in combination with other deferred tax assets of the same type.

The amendment is effective from January 2017.

Worked example: Deferred tax asset and unrealised losses

(Adapted from IAS 12, Illustrative Example 7)

Humbert owns a debt instrument with a nominal value of £2,000,000. The fair value of the financial instrument at the company's year end of 30 June 20X4 is £1,800,000. Humbert has determined that there is a deductible temporary difference of £200,000. Humbert intends to hold the instrument until maturity on 30 June 20X5, and expects that the £2,000,000 will be paid in full. This means that the deductible temporary difference will reverse in full.

Humbert has, in addition, £60,000 of taxable temporary differences that will also reverse in full in 20X5. The company expects the bottom line of its tax return to show a tax loss of £40,000.

Assume a tax rate of 20%.

Requirement

Discuss, with calculations, whether Humbert can recognise a deferred tax asset under IAS 12, *Income Taxes*.

Solution

The first stage is to use the reversal of the taxable temporary difference to arrive at the amount to be tested for recognition.

Under IAS 12 Humbert will consider whether it has a tax liability from a taxable temporary difference that will support the recognition of the tax asset:

	£'000
Deductible temporary difference	200
Reversing taxable temporary difference	(60)
Remaining amount (recognition to be determined)	140

At least £60,000 may be recognised as a deferred tax asset.

The next stage is to calculate the future taxable profit. Following the amendment, this is done using a formula, the aim of which is to derive the amount of tax profit or loss before the reversal of any temporary difference:

	£'000
Expected tax loss (per bottom line of tax return)	(40)
Less reversing taxable temporary difference	(60)
Add reversing deductible temporary difference	200
Taxable profit for recognition test	100

Finally, the results of the above two steps should be added, and the tax calculated:

Humbert would recognise a deferred tax asset of (£60,000 + £100,000) × 20% = £32,000. This deferred tax asset would be recognised even though the company has an expected loss on its tax return.

7 Group scenarios

Section overview

- In relation to business combinations and consolidations, IAS 12 gives examples of circumstances that give rise to taxable temporary differences and to deductible temporary differences in an appendix.
- As already mentioned, however, the initial recognition of goodwill has no deferred tax impact.

7.1 General principles

There are some temporary differences which only arise in a business combination. This is because, on consolidation, adjustments are made to the carrying amounts of assets and liabilities that are not always reflected in the tax base of those assets and liabilities.

The tax bases of assets and liabilities in the consolidated financial statements are determined by reference to the applicable tax rules. Usually tax authorities calculate tax on the profits of the individual entities, so the relevant tax bases to use will be those of the individual entities.

Deferred tax calculation

(IAS 12.11)

	$	
Carrying amount of asset/liability (consolidated statement of financial position)	X/(X)	Carrying amount in **consolidated** statement of financial position
Tax base (usually subsidiary's tax base)	(X)/X	Tax base depends on tax rules. Usually tax is charged on **individual entity profits**, **not** group profits.
Temporary difference	X/(X)	
Deferred tax (liability)/asset	(X)/X	

7.2 Taxable temporary differences

7.2.1 Fair value adjustments on consolidation

IFRS 3, *Business Combinations* requires assets acquired on acquisition of a subsidiary to be recognised at their fair value rather than their carrying amount in the individual financial statements of the subsidiary. The fair value adjustment does not, however, have any impact on taxable profits or the tax base of the asset. This is much like a revaluation in an individual company's accounts.

Therefore an upwards fair value adjustment made to an asset will result in the carrying value of the asset exceeding the tax base and so a taxable temporary difference will arise.

The resulting deferred tax liability is recorded in the consolidated accounts by:

DEBIT	Goodwill (group share)	X	
CREDIT	Deferred tax liability		X

Worked example: Fair value adjustments

On 1 September 20X8, Hunt acquired 80% of the ordinary share capital of Harrison for consideration totalling £150,000. At the date of acquisition, Harrison's statement of financial position showed net assets of £180,000, although the fair value of inventory was assessed to be £10,000 above its carrying amount.

Requirement

Explain the deferred tax implications, assuming a tax rate of 30%.

Solution

Implications:

- The carrying amount of the inventory in the group accounts is £10,000 more than its tax base (being carrying amount in Harrison's own accounts).
- Deferred tax on this temporary difference is 30% × £10,000 = £3,000.
- A deferred tax liability of £3,000 is recognised in the group statement of financial position.
- Goodwill is increased by (£3,000 × 80%) = £2,400.

7.2.2 Undistributed profits of subsidiaries, branches, associates and joint ventures

(a) The carrying amount of, for example, a subsidiary in consolidated financial statements is equal to the group share of the net assets of the subsidiary plus purchased goodwill.

(b) The tax base is usually equal to the cost of the investment.

(c) The difference between these two amounts is a temporary difference. It can be calculated as the parent's share of the subsidiary's post-acquisition profits which have not been distributed.

Worked example: Temporary difference in subsidiary holding

Askwith purchased 80% of the ordinary share capital of Embsay for £110,000 when the net assets of Embsay were £100,000, giving rise to goodwill of £30,000. At 31 December 20X6 the following is relevant:

(1) Goodwill has not been impaired.

(2) The net assets of Embsay amount to £120,000.

Requirement

What temporary difference arises on this investment at 31 December 20X6?

Solution

Temporary difference:

- The tax base of the investment in Embsay is the cost of £110,000. The carrying value is the share of net assets (80% × £120,000) + goodwill of £30,000 = £126,000.
- The temporary difference is therefore £126,000 – £110,000 = £16,000.
- This is equal to the group share of post-acquisition profits: 80% × £20,000 change in net assets since acquisition.

Recognition of deferred tax

A deferred tax liability should be recognised on the temporary difference unless:

- the parent/investor/venturer is able to control the timing of the reversal of the temporary difference; **and**
- it is probable that the temporary difference will not reverse (ie, the profits will not be paid out) in the foreseeable future.

This can be applied to different levels of investment as follows:

(a) **Subsidiary**

As a parent company can control the dividend policy of a subsidiary, deferred tax will not arise in relation to undistributed profits.

(b) **Associate**

An investor in an associate does not control that entity and so cannot determine its dividend policy. Without an agreement requiring that the profits of the associate should not be distributed in the foreseeable future, therefore, an investor should recognise a deferred tax liability arising from taxable temporary differences associated with its investment in the associate. Where an investor cannot determine the exact amount of tax, but only a minimum amount, then the deferred tax liability should be that amount.

(c) **Joint venture**

In a joint venture, the agreement between the parties usually deals with profit sharing. When a venturer can control the sharing of profits and it is probable that the profits will not be distributed in the foreseeable future, a deferred liability is not recognised.

7.2.3 Changes in foreign exchange rates

Where a foreign operation's taxable profit or tax loss (and therefore the tax base of its non-monetary assets and liabilities) is determined in a foreign currency, changes in the exchange rate give rise to taxable or deductible temporary differences.

These relate to the foreign entity's own assets and liabilities, rather than to the reporting entity's investment in that foreign operation, and so the reporting entity should recognise the resulting deferred tax liability or asset. The resulting deferred tax is charged or credited to profit or loss.

However, a deferred tax asset should **only** be recognised to the extent that both these are probable:

(a) That the temporary difference will **reverse** in the foreseeable future

(b) That **taxable profit** will be available against which the temporary difference can be used

7.3 Deductible temporary differences

7.3.1 Unrealised profits on intra-group trading

(a) From a tax perspective, one group company selling goods to another group company is taxed on the resulting profit in the period that the sale is made.

(b) From an accounting perspective no profit is realised until the recipient group company sells the goods to a third party outside the group. This may occur in a different accounting period from that in which the initial group sale is made.

(c) A temporary difference therefore arises equal to the amount of unrealised intra-group profit. This is the difference between the following:

    (1) Tax base, being cost to the recipient company (ie, cost to selling company plus unrealised intra-group profit on sale to the recipient company)

    (2) Carrying value to the group, being the original cost to the selling company, since the intra- group profit is eliminated on consolidation

(d) Deferred tax is provided at the **receiving** company's tax rate.

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7.3.2 Fair value adjustments

IFRS 3 requires assets and liabilities acquired on acquisition of a subsidiary to be brought in at their fair value rather than the carrying amount. The fair value adjustment does not, however, have any impact on taxable profits or the tax base of the asset.

Therefore a fair value adjustment which increases a recognised liability or creates a new liability will result in the tax base of the liability exceeding the carrying value and so a deductible temporary difference will arise.

A deductible temporary difference also arises where an asset's carrying amount is reduced to a fair value less than its tax base.

The resulting deferred tax asset is recorded in the consolidated accounts by:

DEBIT	Deferred tax asset	X	
CREDIT	Goodwill		X

7.4 Deferred tax assets of an acquired subsidiary

Deferred tax assets of a subsidiary may not satisfy the criteria for recognition when a business combination is initially accounted for but may be realised subsequently.

These should be recognised as follows:

(a) If recognised within 12 months of the acquisition date and resulting from new information about circumstances existing at the acquisition date, the credit entry should be made to goodwill. If the carrying amount of goodwill is reduced to zero, any further amounts should be recognised in profit or loss.

(b) If recognised outside the 12-month 'measurement period' or not resulting from new information about circumstances existing at the acquisition date, the credit entry should be made to profit or loss.

Interactive question 6: Recognition

In 20X2 Jacko Co acquired a subsidiary, Jilly Co, which had deductible temporary differences of £3 million. The tax rate at the date of acquisition was 30%. The resulting deferred tax asset of £0.9 million was not recognised as an identifiable asset in determining the goodwill of £5 million resulting from the business combination. Two years after the acquisition, Jacko Co decided that future taxable profit would probably be sufficient for the entity to recover the benefit of all the deductible temporary differences.

Requirement

State the accounting treatment of the recognition of the deferred tax asset in 20X4. See

Answer at the end of this chapter.

Interactive question 7: Fair value adjustment

Oscar acquired 80% of the ordinary shares in Dorian Limited (Dorian) on 1 July 2005.

At acquisition, a property owned and occupied by Dorian had a fair value £30 million in excess of its carrying value. This property had a remaining useful life at that time of 20 years.

Oscar is preparing its financial statements as at 30 June 2015. The tax rate in the jurisdiction in which Oscar operates is 16%.

Requirements

7.1 How should this fair value difference be recorded in the consolidated financial statements at 30 June 2015?

7.2 What is the deferred tax implication of the fair value adjustment? See **Answer** at the end of this chapter.

Worked example: Deferred tax and groups 1

In recent years, Morpeth Ltd has made the following acquisitions of other companies:

- On 1 January 20X6, it acquired 90% of the share capital of Skipton, resulting in goodwill of £1.4 million.
- On 1 July 20X6 it acquired the whole of the share capital of Bingley for £6 million. At this date the fair value of the net assets of Bingley was £4.5 million and their tax base was £4 million.

The following information is relevant to Morpeth Group's year ended 31 December 20X6:

Skipton

(1) Skipton has made a provision amounting to £1.8 million in its accounts in respect of litigation. This is tax allowable only when the cost is actually incurred. The case is expected to be settled within 12 months.

(2) Skipton has a number of investments classified as at fair value through profit or loss in accordance with IFRS 9, *Financial Instruments*. The remeasurement gains and losses recognised in profit or loss for accounting purposes are not taxable/tax allowable until such date as the investments are sold. To date the cumulative unrealised gain is £2.5 million.

(3) Skipton has sold goods to Morpeth in the year making a profit of £1 million. A quarter of these goods remain in Morpeth's inventory at the year end.

Bingley

(1) At its acquisition date, Bingley had unrelieved brought-forward tax losses of £0.4 million. It was initially believed that Bingley would have sufficient taxable profits to use these losses and a deferred tax asset was recognised in Bingley's financial statements at acquisition. Subsequent events have proven that the future taxable profits will not be sufficient to use the full brought- forward loss.

(2) At acquisition Bingley's retained earnings amounted to £3.5 million. The directors of Morpeth Group have decided that in each of the next four years to the intended listing date of the group, they will realise earnings through dividend payments from the subsidiary amounting to £600,000 per annum. Bingley has not declared a dividend for the current year. Tax is payable on remittance of dividends.

(3) £300,000 of the purchase price of Bingley has been allocated to intangible assets. The recognition and measurement criteria of IFRS 3 and IAS 38 do not appear to have been met; however, the directors believe that the amount is allowable for tax and have calculated the tax charge accordingly. It is believed that this may be challenged by the tax authorities.

Requirement

What are the deferred tax implications of the above issues for the Morpeth Group?

Solution

Acquisitions

Any fair value adjustments made for consolidation purposes will affect the group deferred tax charge for the year.

A taxable temporary difference will arise where the fair value of an asset exceeds its carrying value, and the resulting deferred tax liability should be recorded against goodwill.

A deductible temporary difference will arise where the fair value of a liability exceeds its carrying value, or an asset is revalued downwards. Again the resulting deferred tax amount (an asset) should be recognised in goodwill.

In addition, it may be possible to recognised deferred tax assets in a group which could not be recognised by an individual company. This is the case where tax losses brought forward, but not considered to be an asset, due to lack of available taxable profits to set them against, can now be used by another group company.

Goodwill

Goodwill arose on both acquisitions. According to IAS 12, however, no provision should be made for the temporary difference arising on this.

Skipton

(1) A deductible temporary difference arises when the provision is first recognised. This results in a deferred tax asset calculated as £540,000 (30% × £1.8m). The asset may, however, only be recognised where it is probable that there will be future taxable profits against which the future tax-allowable expense may be set. There is no indication that this is not the case for Skipton.

(2) A taxable temporary difference arises where investments are revalued upwards for accounting purposes but the uplift is not taxable until disposal. In this case the carrying value of the investments has increased by £2.5 million, and this has been recognised in profit or loss. The tax base has not, however changed. Therefore, a deferred tax liability should be recognised on the £2.5 million, and, in line with the recognition of the underlying revaluation, this should be recognised in profit or loss.

(3) This intra-group transaction results in unrealised profits of £250,000 which will be eliminated on consolidation. The tax on this £250,000 will, however, be included within the group tax charge (which is comprised of the sum of the individual group companies' tax charges). From the perspective of the group there is a temporary difference. Deferred tax should be provided on this difference using the tax rate of Morpeth (the recipient company).

Bingley

(1) Unrelieved tax losses give rise to a deferred tax asset only where the losses are regarded as recoverable. They should be regarded as recoverable only where it is probable that there will be future taxable profits against which they may be used. It is indicated that the future profits of Bingley will not be sufficient to realise all of the brought-forward loss, and therefore the deferred tax asset is calculated only on that amount expected to be recovered.

(2) Deferred tax is recognised on the unremitted earnings of investments, except where:

    (a) The parent is able to control the payment of dividends

    (b) It is unlikely that the earnings will be paid out in the foreseeable future

    Morpeth controls Bingley and is therefore able to control its dividend payments; however, it is indicated that £2.4 million will be paid as dividends in the next four years. Therefore a deferred tax liability related to this amount should be recognised.

(3) The directors have assumed that the £300,000 relating to intangible assets will be tax allowable, and the tax provision has been calculated based on this assumption. However, this is not certain, and extra tax may have to be paid if this amount is not allowable. Therefore a liability for the additional tax amount should be recognised.

Interactive question 8: Intangible

Jenner Holdings (Jenner) operates in the recruitment industry. On 1 February 20X0, Jenner acquired 60% of Rannon. It is now 31 March 20X4, and the consolidated financial statements of Jenner are being prepared.

On the date of acquisition, £40,800,000 of the purchase consideration was allocated to the domain name 'www.alphabettajob.com' which Rannon had registered some years earlier. Alphabettajob.com is a popular job search website well known in the recruitment industry and as a result Jenner was able to establish a fair value using an income-based valuation method. The domain name is not recognised in Rannon's individual financial statements and has a tax base of nil.

The Jenner Group amortises acquired domain names over 10 years. The tax rate applicable to the profits of both companies is 17%.

Requirement

Prepare journals and explanations to show how this domain name should be treated in the consolidated financial statements of the Jenner Group as at 31 March 20X4.

See **Answer** at the end of this chapter.

Interactive question 9: Deferred tax and groups

Menston, a limited company, has two wholly owned subsidiaries, Burley, another UK company and Rhydding, which is located in Estomania. The following information is relevant to the year ended 31 August 20X8:

(1) Rhydding has made a tax-adjusted loss equivalent to £6.5 million. This loss can only be relieved through carry forward against future profits of Rhydding.

(2) During the year Burley has sold goods to Menston for £12 million, based on a 20% mark-up. Half of these goods are still in Menston's stock room at the year end.

Assume that the tax rate applicable to the group companies based in the UK is 30%; the Estomanian tax rate is 20%.

Requirement

What are the deferred tax implications of these issues? See **Answer** at the end of this chapter.

Interactive question 10: Deferred tax scenarios

Angelo, a public limited company, has three 100% owned subsidiaries, Claudio, Lucio and Escalus SA, a foreign subsidiary.

(1) The following details relate to Claudio:

  (a) Angelo acquired its interest in Claudio on 1 January 20X3. The fair values of the assets and liabilities acquired were considered to be equal to their carrying amounts, with the exception of freehold property which was considered to have a fair value of £1 million in excess of its book value. The directors have no intention of selling the property.

(b) Claudio has sold goods at a price of £6 million to Angelo since acquisition and made a profit of £2 million on the transaction. The inventories of these goods recorded in Angelo's statement of financial position at the year end, 30 September 20X3, were £3.6 million.

(2) Lucio undertakes various projects from debt factoring to investing in property and commodities. The following details relate to Lucio for the year ended 30 September 20X3:

(a) Lucio has a portfolio of readily marketable government securities which are held as current assets for financial trading purposes. These investments are stated at market value in the statement of financial position with any gain or loss taken to profit or loss. These gains and losses are taxed when the investments are sold. Currently the accumulated unrealised gains are £8 million.

(b) Lucio has calculated it requires an allowance for credit losses of £2 million against its total loan portfolio. Tax relief is available when a specific loan is written off.

(c) Escalus SA has unremitted earnings of €20 million which would give rise to additional tax payable of £2 million if remitted to Angelo's tax regime. Angelo intends to leave the earnings within Escalus for reinvestment.

(d) Angelo has unrelieved trading losses as at 30 September 20X3 of £10 million.

Current tax is calculated based on the individual company's financial statements (adjusted for tax purposes) in the tax regime in which Angelo operates. Assume an income tax rate of 30% for Angelo and 25% for its subsidiaries.

Requirement

Explain the deferred tax implications of the above information for the Angelo group of companies for the year ended 30 September 20X3.

See **Answer** at the end of this chapter.

Interactive question 11: Foreign branch

Investa has a foreign branch which has the same functional currency as Investa (the pound sterling). The branch's taxable profits are determined in dinars. On 1 May 20X3, the branch acquired a property for 6 million dinars. The property had an expected useful life of 12 years with a zero residual value. The asset is written off for tax purposes over eight years. The tax rate in Investa's jurisdiction is 30% and in the branch's jurisdiction is 20%. The foreign branch uses the cost model for valuing its property and measures the tax base at the exchange rate at the reporting date.

Investa would like an explanation (including a calculation) as to why a deferred tax charge relating to the asset arises in the group financial statements for the year ended 30 April 20X4 and the impact on the financial statements if the tax base had been translated at the historical rate.

The exchange rate was 5 dinars: £1 on 1 May 20X3 and 6 dinars: £1 on 30 April 20X4.

Requirement

Provide the explanation and calculation requested.

See **Answer** at the end of this chapter.

8 Presentation and disclosure

Section overview

The detailed presentation and disclosure requirements for current and deferred tax are given below.

8.1 Disclosure requirements

The tax expense (income) related to profit (or loss) from ordinary activities should be presented on the face of the statement of profit or loss and other comprehensive income.

The following are the main items that should be disclosed separately:

(a) Current tax expense (income)

(b) Any adjustments recognised in the period for current tax of prior periods

(c) The amount of deferred tax expense (income) relating to temporary differences

(d) The amount of deferred tax expense (income) relating to changes in tax rates or the imposition of new taxes

(e) Prior period deferred tax or current tax adjustments

(f) The aggregate current and deferred tax relating to items that are charged or credited to equity

(g) An explanation of the relationship between tax expense (income) and accounting profit which can be done in either (or both) of the following ways:

 (1) A numerical reconciliation between tax expense and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which the applicable tax rate(s) is (are) computed

 (2) A numerical reconciliation between the average effective tax rate and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed

(h) An explanation of changes in the applicable tax rate(s) compared to the previous accounting period

(i) The amount of deductible temporary differences, unused tax losses and unused tax credits for which no deferred tax asset is recognised in the statement of financial position

8.2 The statement of financial position

Tax assets and tax liabilities should be presented separately from other assets and liabilities in the statement of financial position. Deferred tax assets and liabilities should be distinguished from current tax assets and liabilities.

Deferred tax assets (liabilities) should **not** be classified as current assets (liabilities). This is the case even if the deferred tax assets/liabilities are expected to be realised within 12 months.

There is no requirement in IAS 12 to disclose the tax base of assets and liabilities on which deferred tax has been calculated.

8.2.1 Offsetting

Where appropriate deferred tax assets and liabilities should be offset in the statement of financial position.

An entity should offset deferred tax assets and deferred tax liabilities if, and only if:

- the entity has a legally enforceable right to set off current tax assets against current tax liabilities; and
- the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same taxation authority.

There is no requirement in IAS 12 to provide an explanation of assets and liabilities that have been offset.

8.2.2 Other disclosures

An entity should disclose any tax-related contingent liabilities, and contingent assets, in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*. Contingent liabilities and contingent assets may arise, for example, from unresolved disputes with the taxation authorities.

Similarly, where changes in tax rates or tax laws are enacted or announced after the reporting date, an entity should disclose any significant effect of those changes on its current and deferred tax assets and liabilities (see IAS 10, Events After the Reporting Period).

Interactive question 12: Tax adjustment

In the notes to the financial statements of Tacks for the year ended 30 November 20X2, the tax expense included an amount in respect of 'Adjustments to current tax in respect of prior years' and this expense has been treated as a prior year adjustment. These items related to adjustments arising from tax audits by the authorities in relation to previous reporting periods.

The issues that resulted in the tax audit adjustment were not a breach of tax law but related predominantly to transfer pricing issues, for which there was a range of possible outcomes that were negotiated during 20X2 with the taxation authorities. Further at 30 November 20X1, Tacks had accounted for all known issues arising from the audits to that date and the tax adjustment could not have been foreseen as at 30 November 20X1, as the audit authorities changed the scope of the audit. No penalties were expected to be applied by the taxation authorities.

Requirement

What is the correct treatment of the above issue in the financial statements for the year ended 30 November 20X2?

See **Answer** at the end of this chapter.

9 Deferred tax summary and practice

Section overview

- The calculation and recording of deferred tax can be set out in an eight-step process.
- Deferred tax at Advanced Level will be much more demanding than at Professional Level.

9.1 Summary

The following is a summary of the steps required to calculate and record deferred tax in the financial statements.

	Procedure	Comment
Step 1	Determine the carrying amount of each asset and liability in the statement of financial position.	This is merely the carrying value determined by other standards.
Step 2	Determine the tax base of each asset and liability.	This is the amount attributed to each asset or liability for tax purposes.
Step 3	Determine any temporary differences (these are based on the difference between the figures in Step 1 and Step 2).	These will be either: • taxable temporary differences; or • deductible temporary differences.
Step 4	Determine the deferred tax balance by multiplying the tax rate by any temporary differences.	The tax rate to be used is that expected to apply when the asset is realised or the liability settled, based on laws already enacted or substantively enacted by the statement of financial position date.
Step 5	Recognise deferred tax assets/liabilities in the statement of financial position.	Apply recognition criteria in IAS 12.
Step 6	Recognise deferred tax, normally in profit or loss (but possibly as other comprehensive income or in equity or goodwill).	This will be the difference between the opening and closing deferred tax balances in the statement of financial position.
Step 7	Offset deferred tax assets and liabilities in the statement of financial position where appropriate.	Offset criteria in IAS 12 must be satisfied.
Step 8	Comply with relevant presentation and disclosure requirements for deferred tax in IAS 12.	See relevant presentation and disclosure requirements sections above.

The method described is referred to as the liability method, or full provision method.

(a) The **advantage** of this method is that it recognises that each temporary difference at the reporting date has an effect on future tax payments, and these are provided for in full.

(b) The **disadvantage** of this method is that, under certain types of tax system, it gives rise to large liabilities that may fall due only far in the future.

Professional skills focus: Structuring problems and solutions

The step-by-step approach in the above table can be used to structure most problems relating to deferred tax.

9.2 Exam-standard question practice

Deferred tax is still an important topic. The interactive question below is exam-standard and, in addition to testing deferred tax in depth, also tests foreign currency translation of a non-monetary asset and impairment of a previously revalued asset, a financial instrument and a provision. Finally it asks for a re-draft of a statement of financial position following adjustments, which is a typical feature of Question 2 of the Corporate Reporting exam.

Professional skills focus: Assimilating and using information

The exam-standard question below requires assimilation of a great deal of information, not all of which relates to tax. Before launching into the question, it might be helpful to highlight the information that has deferred tax implications while the content of this chapter is fresh in your mind.

Interactive question 13: Exam-standard question

You are Richard Carpenter, a newly-qualified Chartered Accountant, working in the finance department at Chippy plc, a sportswear company with a number of subsidiaries in the UK and overseas. On 1 October 20X2, Chippy acquired 100% of the ordinary shares of Marusa Inc, a sportswear company based in Ruritania. The national currency of Ruritania is the krown (Kr).

You receive the following email from Ying Cha, the finance director of Chippy:

To: Richard Carpenter

From: Ying Cha

Date: 4 November 20X3

Subject: Marusa financial statements for the year ended 30 September 20X3 and advice on parent company transactions

Richard,

Marusa's finance director, Sian Parsons, has provided a draft statement of financial position which has been prepared using Ruritanian GAAP (**Exhibit 1**). This needs to be restated using IFRS before we consolidate Marusa's results. Marusa achieved break-even for the year and the company has no current tax liability.

Sian has also prepared some notes (**Exhibit 2**) that detail key transactions for the year ended 30 September 20X3.

There is no deferred tax under Ruritanian GAAP, but I am particularly concerned about the deferred tax implications of some of the key transactions under IFRS.

I would also like your advice regarding the deferred tax treatment of a UK subsidiary in the financial statements of Chippy, the parent company. I have prepared a note on the relevant issue (**Exhibit 3).**

I would like you to do the following:

- For each of the key transactions (Exhibit 2):
- Explain any adjustments which need to be made to ensure that Marusa's financial statements comply with IFRS.
- Prepare the journal entries needed to adjust Marusa's financial statements to IFRS.
- Prepare a revised statement of financial position for Marusa at 30 September 20X3 in accordance with IFRS, showing all workings clearly.
- Explain the deferred tax treatment relating to the subsidiary in the financial statements of Chippy.

Please prepare your figures to the nearest Kr'000.

Requirement

Respond to Ying Cha's instructions.

Exhibit 1: Marusa – Draft statement of financial position at 30 September 20X3

	Kr'000
Non-current assets	
Property, plant & equipment	61,600
Intangible assets	8,500
Financial investments	7,700
	77,800
Current assets	23,700
	101,500
Equity and liabilities Equity	
Share capital Kr1 shares	10,000
Retained earnings	42,600
Revaluation surplus	16,800
	69,400
Non-current liabilities	
Loans	10,000
Provisions	15,000
Current liabilities	7,100
	101,500

Exhibit 2: Notes prepared by Sian Parsons: Key transactions in the year ended 30 September 20X3

(1) **Purchase of machinery**

On 1 January 20X3 Marusa bought some specialist machinery from the USA for $30 million. Payment for the machinery was made on 31 March 20X3.

In accordance with local Ruritanian GAAP, I recognised the cost of the machinery on 1 January 20X3 at Kr10 million, using the opening rate of exchange at 1 October 20X2.

I have charged a full year's depreciation of Kr1.0 million in cost of sales, as Marusa depreciates the machinery over a 10-year life and it has no residual value. I have therefore included the machinery in the statement of financial position at Kr9 million.

An amount of Kr2.5 million has been debited to retained earnings. This is in respect of the difference between the sum paid to the supplier of Kr12.5 million on 31 March 20X3 and the cost recorded in non-current assets of Kr10 million.

The Kr/US$ exchange rates on relevant dates were:

	1 Kr =
1 October 20X2	$3.00
1 January 20X3	$2.50
31 March 20X3	$2.40
30 September 20X3	$2.00

In Ruritania the tax treatment of property, plant and equipment and exchange differences is the same as the IFRS treatment.

(2) **Impairment**

Marusa bought a warehouse on 1 October 20W3 for Kr36 million. The warehouse is being depreciated over 20 years with no residual value. On 1 October 20X2, due to a rise in property prices, the warehouse was revalued to Kr42 million and a revaluation surplus of Kr16.8 million was recognised. No transfers are made between the revaluation surplus and retained earnings under Ruritanian GAAP in respect of depreciation.

There has been a slump in the local property market recently, so an impairment review was undertaken at 30 September 20X3, and the warehouse was assessed as being worth Kr12 million. I have therefore charged Kr18 million to profit or loss to reflect the difference between the carrying amount of the warehouse of Kr30 million before 30 September 20X3 and the new value of Kr12 million.

(3) **Investment**

On 1 April 20X3, Marusa bought one million shares in a local listed company for Kr7.70 per share. This represents a 3% shareholding. The intention is to hold the shares until 31 December 20X3, and then sell them at a profit. I have recognised the shares at cost in the statement of financial position in accordance with Ruritanian GAAP. The market value of the shares at 30 September 20X3 was Kr12.50 per share.

Under Ruritanian tax rules, income tax is charged at 20% on the accounting profit recognised on the sale of the investment.

(4) **Provision**

On 1 October 20X2, Marusa signed an agreement with the Ruritanian government for exclusive rights for the next 20 years to the organic cotton grown on government-owned land. The cost of buying these rights was Kr8.5 million, which has been recognised in intangible assets in Marusa's statement of financial position. Under the terms of the rights agreement, Marusa has to repair any environmental damage at the end of the 20-year period.

There is a 40% probability of the eventual cost of environmental repairs being Kr15 million and a 60% probability of the cost being Kr10 million. To be prudent I have created a provision for Kr15 million, and debited this to operating costs. Marusa has a pre-tax discount rate of 8%. The environmental costs will be allowed for tax purposes when paid. The income tax rate is expected to remain at 20%.

Exhibit 3: Note prepared by Ying Cha: Key transactions in the year ended 30 September 20X3

Gemex, a limited liability company, is a wholly owned UK subsidiary of Chippy, and is a cash generating unit in its own right. The value of the property, plant and equipment of Gemex at 30 September 20X3 was £6 million and purchased goodwill was £1 million before any impairment loss. The company had no other assets or liabilities. An impairment loss of £1.8 million had occurred at 30 September 20X3. The tax base of the property, plant and equipment of Gemex was £4 million as at 30 September 20X3.

I would like to know how the impairment loss will affect the deferred tax liability for the year in the financial statements of Chippy. Impairment losses are not an allowable expense for taxation purposes. The corporation tax rate is 20%.

See **Answer** at the end of this chapter.

10 Audit focus

Section overview

- The provision for and related statement of profit or loss entries for deferred taxation are based on assumptions that rely on management judgements.
- Procedures should be adopted to ensure any assumptions are reasonable and the requirements of IAS 12 have been met.

10.1 Auditing tax

10.1.1 Audit risks

Until recently, tax accounting has been of secondary concern in the corporate group reporting process. The tax figures in the financial statements are, however, often material by their nature, and the increased public interest around tax avoidance now places greater pressure on companies and groups to get tax reporting right.

The following factors increase the audit risk in respect of current and deferred tax, particularly in a group reporting context:

- Lack of tax accounting knowledge: even in larger groups with in-house tax specialist resource, the board is often more interested in the cash cost of tax than in tax accounting, although getting the tax rate in line with analysts' expectations does still promote investor confidence.
- Lack of foreign tax knowledge: the tax figures of foreign operations are particularly at risk of misstatement, and auditing them may require specialist knowledge.
- Complex or unusual transactions: the tax implications of such transactions may be overlooked by management, but they can be complex and material.
- Lack of appropriate tax reporting processes: the basic processes (such as Excel file) used by many entities are unable to respond to complex tax reporting requirements. The use of manual input increases the risk of errors, and may render workings difficult to audit.

Professional skills focus: Applying judgement

Where there is risk, the application of judgement is needed; for example, whether to use a tax specialist or whether there is sufficient knowledge within the audit team.

10.1.2 Use of tax specialists

On the audit of larger or more complex entities, tax audit specialists are likely to be actively involved from the start of the audit as members of the audit team, using their tax accounting expertise to carry out the review of tax figures in the statement of financial position and statement of profit or loss. In such cases, the tax audit team will report their findings, including any identified misstatements and any areas of significant uncertainty, to the audit team. The tax team's workings papers must be included within the audit working papers file.

Note: In accordance with the revised Ethical Standard the provision of tax services by an audit firm for PIEs is prohibited.

Professional skills focus: Concluding, recommending and communicating

The language of financial reporting differs from that of tax. It is important that the tax team communicates its findings clearly to the audit team, since it is in essence providing a service to the audit team which the audit team will rely on.

10.1.3 Current tax: audit procedures

Auditors (or the tax specialists involved in the audit) should carry out audit procedures including the following:

- Obtain copies of the prior period tax computation.
- Inquire whether any tax enquiries have been raised by the tax authorities in the period.
- Inquire into the status of any unresolved tax enquiries, and obtain supporting correspondence with the tax authorities.
- Obtain copies of the current period tax computation, and evaluate whether:
  - the opening balances agree to the closing balances in the prior period tax computation;
  - the figures in the tax computation agree to figures in the financial statements;
  - estimates contained within the tax computation are based on reasonable assumptions; and
  - all tax rates and allowances are based on applicable tax legislation.
- Review details of tax payments made/refunds received in the period, and agree payments to the cash and bank account.

10.1.4 Deferred tax: audit procedures

The following procedures will be relevant:

- Assess whether it is appropriate for the company to recognise deferred tax (eg, is the company expected to make future taxable profits against which the deferred tax would unwind?).
- Obtain a copy of the deferred tax workings.
- Determine the arithmetical **accuracy** of the deferred tax working.
- Agree the **figures used** to calculate temporary differences to those on the **tax computation** and the **financial statements.**
- Review the assumptions made in the light of the auditor's knowledge of the business and any other evidence gathered during the course of the audit to ensure reasonableness.
- Agree the opening position on the deferred tax account to the prior year financial statements.
- Review the basis of the provision to ensure:
  - it is in line with accounting practice under IAS 12, *Income Taxes*; and
  - any changes in accounting policy have been disclosed.
- Verify that the rate of corporation tax at which the deferred tax asset/liability unwinds is appropriate and in line with current tax legislation.
- To test for **completeness** (understatement) the auditor should review the draft financial statements to identify items that would normally be expected to give a temporary difference and ensure they have been included.

10.1.5 Transfer pricing

Besides auditing current and deferred tax, transfer pricing is an important area over which sufficient appropriate audit evidence must be sought. When the entity's transfer pricing policies are challenged by the tax authorities, the effect on the company's current tax position over several years is likely to be material.

Please refer to Corporate Tax Planning workbook of professional level for a more detailed discussion of transfer pricing.

Context example: Petrofac plc

Petrofac plc is a global oil and gas services company, listed on FTSE 250. In the group financial statements for the year ended 31 December 2014, tax accounting was identified as an area of particular audit risk by the group auditor, Ernst & Young. The following excerpts from the auditor's report for the period describe the risk, and the audit team's responses to the risk.

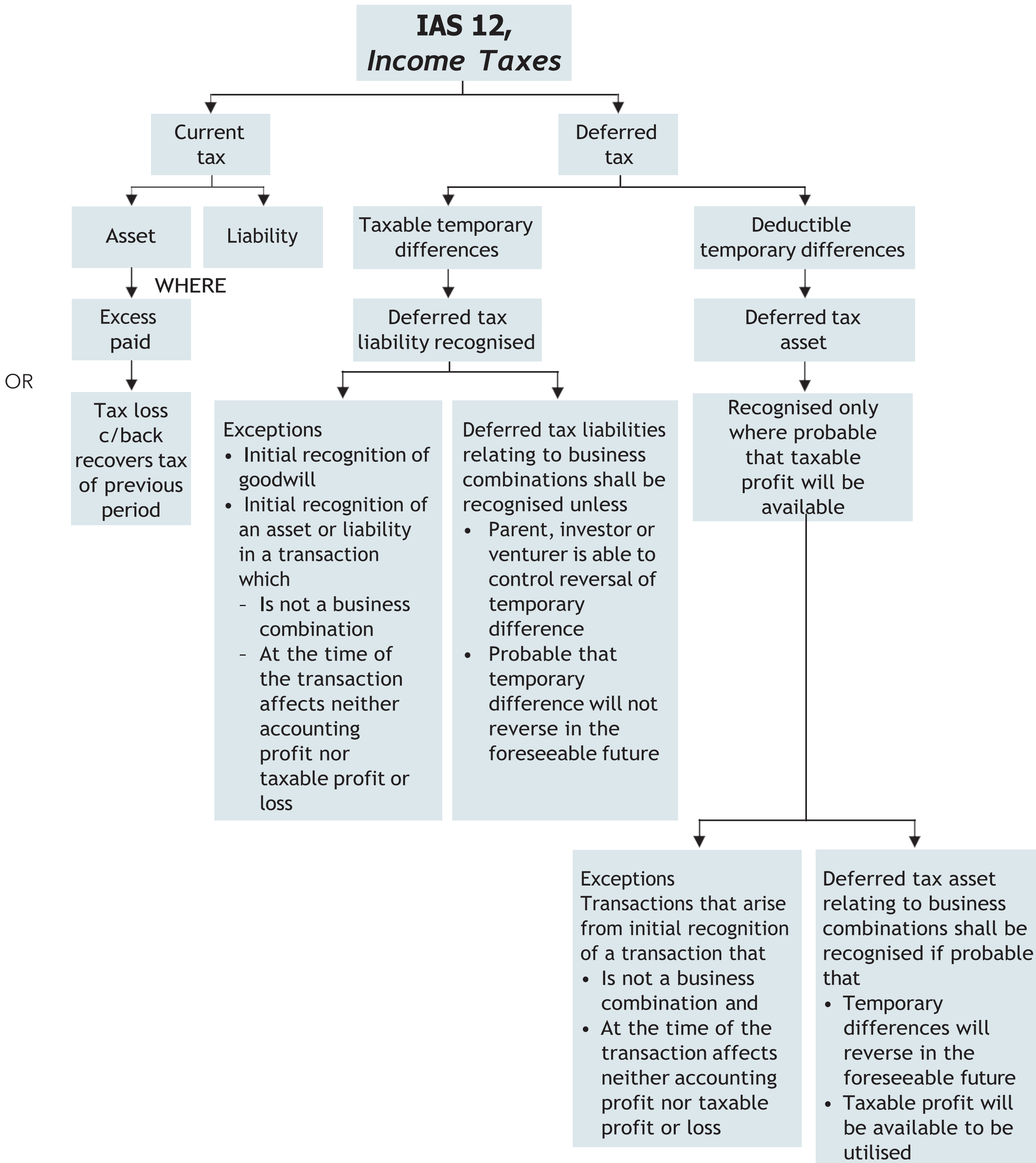
Accounting for taxation assets, liabilities, income and expenses Area of risk

The wide geographical spread of the Group's operations, the complexity of application of local tax rules in many different jurisdictions and transfer pricing risks affecting the allocation of income and costs charged between jurisdictions and businesses increase the risk of misstatement of tax balances. The assessment of tax exposures by Management requires judgement given the structure of individual contracts and the increasing activity of tax authorities in the jurisdictions in which Petrofac operates. Furthermore, the recognition of deferred tax assets and liabilities needs to be reviewed regularly to ensure that any changes in local tax laws and profitability of associated contracts are appropriately considered. Refer to note 7 of the financial statements for disclosures in respect of taxation for the year.

Audit approach

We used tax specialists in our London team in the planning stages to determine which jurisdictions should be in scope, as well as in the audit of tax balances. We also involved local tax specialists in the relevant jurisdictions where we deemed it necessary. We considered and challenged the tax exposures estimated by management and the risk analysis associated with these exposures along with claims or assessments made by tax authorities to date. We also audited the calculation and disclosure of current and deferred tax (refer to Note 7) to ensure compliance with local tax rules and the Group's accounting policies including the impact of complex items such as share based payments and the review of management's assessment of the likelihood of the realisation of deferred tax balances.

Summary



IAS 12, *Income Taxes*
Current tax
Deferred tax
Asset
Liability
WHERE
Excess paid
OR
Tax loss c/back recovers tax of previous period
Taxable temporary differences
Deferred tax liability recognised
Exceptions
• Initial recognition of goodwill
• Initial recognition of an asset or liability in a transaction which
– Is not a business combination
– At the time of the transaction affects neither accounting profit nor taxable profit or loss
Deferred tax liabilities relating to business combinations shall be recognised unless
• Parent, investor or venturer is able to control reversal of temporary difference
• Probable that temporary difference will not reverse in the foreseeable future
Deductible temporary differences
Deferred tax asset
Recognised only where probable that taxable profit will be available
Exceptions
Transactions that arise from initial recognition of a transaction that
• Is not a business combination and
• At the time of the transaction affects neither accounting profit nor taxable profit or loss
Deferred tax asset relating to business combinations shall be recognised if probable that
• Temporary differences will reverse in the foreseeable future
• Taxable profit will be available to be utilised

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Do you understand what IAS 12 means by 'temporary differences'? (Topic 2)
2.	Can you identify the tax base resulting from various tax rules? (Topic 3)
3.	Can you calculate taxable and deductible temporary differences? (Topic 3)
4.	Can you measure the deferred tax liability or asset? (Topic 4)
5.	On what basis is deferred tax recognised in the financial statements? (Topic 5)
6.	How is deferred tax recognised in the context of retirement benefits and share-based payment? (Topic 6)
7.	What factors increase the audit risk in respect of current and deferred tax? (Topic 10)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question Name	Learning benefit from attempting this question
Situations	A straightforward warm-up question, this tests that you have grasped the basic concept behind deferred tax.
Parea	Focusing on property, this question deals with a number of calculations with both taxable and deductible temporary differences.
XYZ	This is a comprehensive deferred tax question requiring calculations and explanations in a group context.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios to help you improve knowledge application and professional skills development before you start the next chapter.

Question Name	Learning benefit from attempting this question
Billinge	This is a full deferred tax question, covering fair value adjustment, share options, intragroup trading, profit from foreign subsidiary, capital allowances and a lease.

Question Name	Learning benefit from attempting this question
Longwood	Another full deferred tax question, this one covers research and development, PPE, tax losses, deferred tax and pensions and deferred tax treatment of goodwill. A thorough understanding of the non-tax issues is required as well as deferred tax.
Telo (note 4 only)	This part of the question relates to gains on investment property being taxed at a different time from gains on PPE. Skim through the answer to note 3, which gives you the information you need about the property to answer the deferred tax part.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving on to the next chapter.

Technical reference

1 **IAS 12, *Income Taxes***

2 **Tax base of an asset/liability – IAS 12.7, IAS 12.8**

3 **Current tax**

- Unpaid current tax recognised as a liability – **IAS 12.12**
- Benefit relating to tax losses that can be carried back to recover previous period current tax recognised as asset – **IAS 12.13**

4 **Taxable temporary differences**

- Deferred tax liability shall be recognised on all taxable temporary differences except those arising from: – **IAS 12.15**
  - Initial recognition of goodwill
  - Initial recognition of an asset or liability in a transaction which:
    - is not a business combination; and
    - at the time of the transaction affects neither accounting profit nor taxable profit (tax loss).

5 **Deductible temporary differences**

- Deferred tax asset shall be recognised for all deductible temporary differences to the extent that taxable profit will be available to be used, unless asset arises from initial recognition of asset or liability in a transaction that: – **IAS 12.24**
  - is not a business combination; and
  - at the time of the transaction affects neither accounting profit nor taxable profit or loss.

6 **Unused tax losses and unused tax credits**

- Deferred tax asset may be recognised in respect of unused tax losses and unused tax credits to the extent that future taxable profits will be available – **IAS 12.34**

7 **Deferred tax assets and liabilities arising from investments in subsidiaries, branches and associates and investments in joint ventures – IAS 12.39, IAS 12.44**

8 **Tax rates and manner of recovery**

- Measurement of deferred tax at tax rates expected to apply when asset realised or liability settled to reflect tax consequences of manner of recovery – **IAS 12.47, 12.51**

9 **Discounting**

- Deferred tax assets and liabilities shall not be discounted – **IAS 12.53**

10 **Annual review**

- Carrying amount of deferred tax asset to be reviewed at each reporting date – **IAS 12.56**

Answer the following questions

1 Torcularis

The Torcularis Company has interest receivable which has a carrying amount of £75,000 in its statement of financial position at 31 December 20X6. The related interest revenue will be taxed on a cash basis in 20X7.

Torcularis has trade receivables that have a carrying amount of £80,000 in its statement of financial position at 31 December 20X6. The related revenue has been included in its statement of profit or loss and other comprehensive income for the year to 31 December 20X6.

Requirement

According to IAS 12, *Income Taxes*, what is the total tax base of interest receivable and trade receivables for Torcularis at 31 December 20X6?

2 Situations

What will the following situations give rise to as regards deferred tax, according to IAS 12, *Income Taxes*?

(a) Development costs have been capitalised and will be amortised through profit or loss, but were deducted in determining taxable profit in the period in which they were incurred.

(b) Accumulated depreciation for a machine in the financial statements is greater than the cumulative capital allowances up to the reporting date for tax purposes.

(c) A penalty payable is in the statement of financial position. Penalties are not allowable for tax purposes.

3 Budapest

On 31 December 20X6, The Budapest Company acquired a 60% stake in The Lisbon Company. Among Lisbon's identifiable assets at that date was inventory with a carrying amount of £8,000 and a fair value of £12,000. The tax base of the inventory was the same as the carrying amount.

The consideration given by Budapest resulted in the recognition of goodwill acquired in the business combination.

Income tax is payable by Budapest at 25% and by Lisbon at 20%.

Requirement

Indicate whether the following statements are true or false, in respect of Budapest's consolidated statement of financial position at 31 December 20X6, in accordance with IAS 12, *Income Taxes*.

(1) No deferred tax liability is recognised in respect of the goodwill.

(2) A deferred tax liability of £800 is recognised in respect of the inventory.

4 Dipyrone

The Dipyrone Company owns 100% of the Reidfurd Company. During the year ended 31 December 20X7:

(1) Dipyrone sold goods to Reidfurd for £600,000, earning a profit margin of 25%. Reidfurd held 30% of these goods in inventory at the year end.

(2) Reidfurd sold goods to Dipyrone for £800,000, earning a profit margin of 20%. Dipyrone held 25% of these goods in inventory at the year end.

The tax base of the inventory in each company is the same as its carrying amount. The tax rate applicable to Dipyrone is 26% and that applicable to Reidfurd is 33%.

What is the deferred tax asset at 31 December 20X7 in Dipyrone's consolidated statement of financial position under IAS 12, *Income Taxes* and IFRS 10, *Consolidated Financial Statements*?

5 Rhenium

The Rhenium Company issued £6 million of 8% loan stock at par on 1 April 20X7. Interest is payable in two instalments on 30 September and 31 March each year.

The company pays income tax at 20% in the year ended 31 December 20X7, but expects to pay at 25% for 20X8 as it will be earning sufficient profits to pay tax at the higher rate.

For tax purposes interest paid and received is dealt with on a cash basis.

Requirement

What is the deferred tax balance at 31 December 20X7, according to IAS 12, *Income Taxes*?

6 Cacholate

The Cacholate Company acquired a property on 1 January 20X6 for £1.5 million. The useful life of the property is 20 years, which is also the period over which tax depreciation is charged.

On 31 December 20X7, the property was revalued to £2.16 million. The tax base remained unaltered.

Income tax is payable at 20%.

Requirement

What is the deferred tax charge for the year ended 31 December 20X7, and where is it charged, under IAS 12, *Income Taxes*?

7 Spruce

Spruce Company made a taxable loss of £4.7 million in the year ended 31 December 20X7. This was due to a one-off reorganisation charge in 20X7; before that, Spruce made substantial taxable profits each year.

Assume that tax legislation allows companies to carry back tax losses for one financial year, and then carry them forward indefinitely.

Spruce's taxable profits are as follows.

Year ended	**£'000**
31 December 20X6	500
31 December 20X8 (estimate)	1,000
31 December 20X9 (estimate)	1,200
31 December 20Y0 and onwards	Uncertain

Spruce pays income tax at 25%.

Requirement

What is the deferred tax balance in respect of tax losses in Spruce's statement of financial position at 31 December 20X7, according to IAS 12, *Income Taxes*?

8 Bananaquit

At 31 December 20X6, The Bananaquit Company has a taxable temporary difference of £1.5 million in relation to certain non-current assets.

At 31 December 20X7, the carrying amount of those non-current assets is £2.4 million and the tax base of the assets is £1.0 million.

Tax is payable at 30%.

Requirement

Indicate whether the following statements are true or false, in accordance with IAS 12, *Income Taxes*.

(1) The deferred tax charge through profit or loss for the year is £30,000.

(2) The statement of financial position deferred tax asset at 31 December 20X7 is £420,000.

9 Antpitta

The Antpitta Company owns 70% of The Chiffchaff Company. During 20X7 Chiffchaff sold goods to Antpitta at a mark-up above cost. Half of these goods are held in Antpitta's inventories at the year end. The rate of income tax is 30%.

Requirement

Indicate whether the following statements are true or false according to IAS 12, *Income Taxes* and IFRS 10, *Consolidated Financial Statements*, when preparing Antpitta's consolidated and Chiffchaff's individual financial statements for the year ended 31 December 20X7.

(1) A deferred tax asset arises in the individual statement of financial position of Chiffchaff in relation to intra-group transactions.

(2) A deferred tax asset arises in Antpitta's consolidated statement of financial position due to the intra-group transactions.

10 Parea

In order to maximise its net assets per share, The Parea Company wishes to recognise the minimum deferred tax liability allowed by IFRS. Parea only pays tax to the Government of Gredonia, at the rate of 22%.

On 1 January 20X6 Parea acquired some plant and equipment for £30,000. In the financial statements it is being written off over its useful life of four years on a straight-line basis, even though tax depreciation is calculated at 27% on a reducing-balance basis.

On 1 January 20X3 Parea acquired a property for £40,000. Both in the financial statements and under tax legislation it is being written off over 25 years on a straight-line basis. On 31 December 20X7 the property was revalued to £50,000 with no change to its useful life, but this revaluation had no effect on the tax base or on tax depreciation.

Requirement

Determine the following amounts for the deferred tax liability of Parea in its consolidated financial statements according to IAS 12, *Income Taxes*.

(1) The deferred tax liability at 31 December 20X6

(2) The deferred tax liability at 31 December 20X7

(3) The charge or credit for deferred tax in profit or loss for the year ended 31 December 20X7

11 XYZ

XYZ, a public limited company, has decided to adopt the provisions of IFRS Standards for the first time in its financial statements for the year ending 30 November 20X1. The amounts of deferred tax provided as set out in the notes of the group financial statements for the year ending 30 November 20X0 were as follows:

	£m
Tax depreciation in excess of accounting depreciation	38
Other temporary differences	11
Liabilities for healthcare benefits	(12)
Losses available for offset against future taxable profits	(34)
	3

The following notes are relevant to the calculation of the deferred tax liability as at 30 November 20X1:

(1) XYZ acquired a 100% holding in a foreign company on 30 November 20X1. The subsidiary does not plan to pay any dividends for the financial year to 30 November 20X1 or in the foreseeable future. The carrying amount in XYZ's consolidated financial statements of its investment in the subsidiary at 30 November 20X1 is made up as follows:

	£m
Carrying amount of net assets acquired excluding deferred tax	76
Goodwill (before deferred tax and impairment losses)	14
Carrying amount/cost of investment	90

The tax base of the net assets of the subsidiary at acquisition was £60 million. No deduction is available in the subsidiary's tax jurisdiction for the cost of the goodwill.

Immediately after acquisition on 30 November 20X1, XYZ had supplied the subsidiary with inventories amounting to £30 million at a profit of 20% on selling price. The inventories had not been sold by the year end and the tax rate applied to the subsidiary's profit is 25%. There was no significant difference between the fair values and carrying amounts on the acquisition of the subsidiary.

(2) The carrying amount of the property, plant and equipment (excluding that of the subsidiary) is £2,600 million and their tax base is £1,920 million. Tax arising on the revaluation of properties of £140 million, if disposed of at their revalued amounts, is the same at 30 November 20X1 as at the beginning of the year. The revaluation of the properties is included in the carrying amount above.

Other taxable temporary differences (excluding the subsidiary) amount to £90 million as at 30 November 20X1.

(3) The liability for healthcare benefits in the statement of financial position had risen to £100 million as at 30 November 20X1 and the tax base is zero. Healthcare benefits are deductible for tax purposes when payments are made to retirees. No payments were made during the year to 30 November 20X1.

(4) XYZ Group incurred £300 million of tax losses in 20X0. Under the tax law of the country, tax losses can be carried forward for three years only. The taxable profits for the years ending 30 November were anticipated to be as follows:

20X1	20X2	20X3
£m	£m	£m
110	100	130

The auditors are unsure about the availability of taxable profits in 20X3, as the amount is based on the projected acquisition of a profitable company. It is anticipated that there will be no future reversals of existing taxable temporary differences until after 30 November 20X3.

(5) Income tax of £165 million on a property disposed of in 20X0 becomes payable on 30 November 20X4 under the deferral relief provisions of the tax laws of the country. There had been no sales or revaluations of property during the year to 30 November 20X1.

(6) Income tax is assumed to be 30% for the foreseeable future in XYZ's jurisdiction and the company wishes to discount any deferred tax liabilities at a rate of 4% if allowed by IAS 12.

(7) There are no other temporary differences other than those set out above. The directors of XYZ have calculated the opening balance of deferred tax using IAS 12 to be £280 million.

Requirement

Calculate the liability for deferred tax required by the XYZ Group at 30 November 20X1 and the deferred tax expense in profit or loss for the year ending 30 November 20X1 using IAS 12, commenting on the effect that the application of IAS 12 will have on the financial statements of the XYZ Group.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

1.1 The tax base of the accrued expenses is nil.

1.2 The tax base of the interest received in advance is nil.

1.3 The tax base of the prepaid expenses is nil.

1.4 The tax base of the loan is £1 million.

Answer to Interactive question 2

(a) The tax base of the asset is £70,000 (£100,000 – £30,000).

Recovery through continued use

Temporary difference of £150,000 – £70,000 = £80,000 is all taxed at 30% resulting in a deferred tax liability of £24,000.

(If the entity expects to recover the carrying amount by using the asset it must generate taxable income of £150,000, but will only be able to deduct depreciation of £70,000.)

(b) **Recovery through sale**

If the entity expects to recover the carrying amount by selling the asset immediately for proceeds of £150,000, the temporary difference is still £80,000. Of this, only the £50,000 excess of proceeds over cost is not taxable. Therefore the deferred tax liability will be computed as follows.

	Taxable temporary difference £	**Tax rate**	**Deferred tax liability £**
Cumulative tax depreciation	30,000	30%	9,000
Proceeds in excess of cost	50,000	Nil	
Total temporary difference	80,000		9,000

Answer to Interactive question 3

(a) **Recovery through continued use**

If the entity expects to recover the carrying amount by using the asset, the situation is as in Recovery 1 above in the same circumstances.

(b) **Recovery through sale**

If the entity expects to recover the carrying amount by selling the asset immediately for proceeds of £150,000, the entity will be able to deduct the indexed cost of £110,000. The net profit of £40,000 will be taxed at 40%. In addition, the cumulative tax depreciation of £30,000 will be included in taxable income and taxed at 30%. On this basis, the tax base is £80,000 (£110,000 – £30,000), there is a taxable temporary difference of £70,000 and there is a deferred tax liability of £25,000 (£40,000 × 40% plus £30,000 × 30%).

Answer to Interactive question 4

Jonquil Co will recover the carrying amount of the equipment by using it to manufacture goods for resale.

Therefore, the entity's current tax computation is as follows.

	20X1	20X2	20X3	20X4	20X5
	£	£	£	£	£
Taxable income*	10,000	10,000	10,000	10,000	10,000
Depreciation for tax purposes	12,500	12,500	12,500	12,500	0
Taxable profit (tax loss)	(2,500)	(2,500)	(2,500)	(2,500)	10,000
Current tax expense (income) at 40%	(1,000)	(1,000)	(1,000)	(1,000)	4,000

* ie, nil profit plus (£50,000 ÷ 5) depreciation add-back.

The entity recognises a current tax asset at the end of years 20X1 to 20X4 because it recovers the benefit of the tax loss against the taxable profit of year 20X0.

The temporary differences associated with the equipment and the resulting deferred tax asset and liability and deferred tax expense and income are as follows.

	20X1	20X2	20X3	20X4	20X5
	£	£	£	£	£
Carrying amount	40,000	30,000	20,000	10,000	0
Tax base	37,500	25,000	12,500	0	0
Taxable temporary difference	2,500	5,000	7,500	10,000	0
Opening deferred tax liability	0	1,000	2,000	3,000	4,000
Deferred tax expense (income): bal fig	1,000	1,000	1,000	1,000	(4,000)
Closing deferred tax liability @ 40%	1,000	2,000	3,000	4,000	0

The entity recognises the deferred tax liability in years 20X1 to 20X4 because the reversal of the taxable temporary difference will create taxable income in subsequent years. The entity's income statement is as follows.

	20X1	20X2	20X3	20X4	20X5
	£	£	£	£	£
Income	10,000	10,000	10,000	10,000	10,000
Depreciation	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)
Profit before tax	0	0	0	0	0
Current tax expense (income)	(1,000)	(1,000)	(1,000)	(1,000)	4,000
Deferred tax expense (income)	1,000	1,000	1,000	1,000	(4,000)
Total tax expense (income)	0	0	0	0	0
Net profit for the period	0	0	0	0	0

Answer to Interactive question 5

The company will recognise an expense for the consumption of employee services given in consideration for share options granted, but will not receive a tax deduction until the share options are actually exercised. Therefore a temporary difference arises and IAS 12, *Income Taxes* requires the recognition of deferred tax.

A deferred tax asset (a deductible temporary difference) results from the difference between the tax base of the services received (a tax deduction in future periods) and the carrying value of zero. IAS 12 requires the measurement of the deductible temporary difference to be based on the intrinsic value of the options at the year end. This is the difference between the fair value of the share and the exercise price of the option.

If the amount of the estimated future tax deduction exceeds the amount of the related cumulative remuneration expense, the tax deduction relates not only to the remuneration expense, but also to equity. If this is the case, the excess should be recognised directly in equity.

Year to 31 May 20X6 Deferred tax asset:

	£
Fair value (40,000 × £8.50 × 1/2)	170,000
Exercise price of option (40,000 × £4.00 × 1/2)	(80,000)
Intrinsic value (estimated tax deduction)	90,000
Tax at 30%	27,000

The cumulative remuneration expense is £60,000, which is less than the estimated tax deduction of £90,000. Therefore:

- a deferred tax asset of £27,000 is recognised in the statement of financial position;
- there is deferred tax income of £18,000 (60,000 × 30%); and
- the excess of £9,000 (30,000 × 30%) goes to equity.

Year to 31 May 20X7 Deferred tax asset:

	£
Fair value	
(40,000 × £8)	320,000
(120,000 × £8 × 1/3)	320,000
	640,000
Exercise price of options	
(40,000 × £4)	(160,000)
(120,000 × £5 × 1/3)	(200,000)
Intrinsic value (estimated tax deduction)	280,000
Tax at 30%	84,000
Less previously recognised	(27000)
	57,000

The cumulative remuneration expense is £220,000, which is less than the estimated tax deduction of £280,000. Therefore:

- a deferred tax asset of £84,000 is recognised in the statement of financial position at 31 May 20X7;

- there is potential deferred tax income of £57,000 for the year ended 31 May 20X7;
- of this, £9,000 (60,000 × 30%) – (9,000) goes directly to equity; and
- the remainder (£48,000) is recognised in profit or loss for the year.

Answer to Interactive question 6

The entity recognises a deferred tax asset of £0.9 million (£3m × 30%) and, in profit or loss, deferred tax income of £0.9 million. Goodwill is not adjusted, as the recognition does not arise within the measurement period (ie, within the 12 months following the acquisition).

Answer to Interactive question 7

7.1 The fair value adjustment to the property reduces goodwill by £24 million (being 80% of the £30m FV adjustment).

As a result of the fair value uplift, the non-controlling interest must be adjusted up by £6 million (20% × £30m).

The journal to record the adjustments to property, goodwill and the NCI at the date of acquisition is:

DEBIT	Property	£30m	
CREDIT	Goodwill		£24m
CREDIT	NCI		£6m

The fair value uplift is subsequently depreciated such that by the reporting date its carrying value is £15 million (10/20 yrs × £30m). The journal to record the consolidation adjustment for extra depreciation is:

DEBIT	Group retained earnings (80% × £15m)	£12m	
DEBIT	NCI (20% × 15,000)	£3m	
CREDIT	Property – accumulated depreciation		£15m

7.2 At acquisition, property held within Dorian's accounts is uplifted by £30 million as a consolidation adjustment.

This results in a taxable temporary difference of £30 million, and so a deferred tax liability of £4.8 million (16% × £30m) at acquisition. This is recognised by:

DEBIT	Goodwill	£3.84m	
DEBIT	Non-controlling interest (20% × £4.8m)	£0.96m	
CREDIT	Deferred tax liability		£4.8m

By the reporting date, £15 million of this temporary difference has reversed and therefore a further journal is required to reduce the deferred tax liability by £2.4 million (16% × £15m):

DEBIT	Deferred tax liability	£2.4m	
CREDIT	Retained earnings (80% × £2.4m)		£1.92m
CREDIT	NCI (20% × £2.4m)		£0.48m

Answer to Interactive question 8

An intangible asset acquired in a business combination is recognised where it meets the definition of an asset and is identifiable ie, it is either separable or arises from contractual or legal rights. This is the case regardless of whether the acquiree recognises the asset on its individual statement of financial position.

The Jenner Group amortises domain names over a 10-year (120 month) period. Rannon was acquired 50 months before the reporting date, therefore the carrying amount of the domain name as at 31 March 20X4 is 70/120 × £40,800,000 = £23,800,000.

A deferred tax liability arises in respect of the fair value adjustment since this results in the carrying amount of the domain name exceeding its tax base of nil. The deferred tax liability is 17% × £23,800,000 = £4,046,000.

Amortisation since acquisition of 50/120 × £40,800,000 = £17,000,000 on the domain name and the £2,890,000 (£17,000,000 × 17%) movement in the associated deferred tax liability must also be accounted for and allocated between group retained earnings and the non-controlling interest:

(1)

DEBIT	Intangible assets		£40,800,000
CREDIT	Goodwill		£40,800,000

To recognise fair value adjustment on acquisition.

DEBIT	Retained earnings (60% × 17% × £40,800,000)	£4,161,600	
DEBIT	Non-controlling interest (40% × 17% × £40,800,000)	£2,774,400	
CREDIT	Deferred tax liability		£6,936,000

To recognise deferred tax liability on fair value adjustment at acquisition. (2)

DEBIT	Retained earnings (60% × £17,000,000)	£10,200,000	
DEBIT	Non-controlling interest (40% × £17,000,000)	£6,800,000	
CREDIT	Intangible assets		£17,000,000

To recognise amortisation on the domain name since acquisition. (3)

DEBIT	Deferred tax liability	£2,890,000	
CREDIT	Retained earnings (60% × £2,890,000)		£1,734,000
CREDIT	Non-controlling interest (40% × £2,890,000)		£1,156,000

To recognise the movement in deferred tax on the fair value adjustment since acquisition.

Answer to Interactive question 9

Implications:

(1) An unrelieved tax loss gives rise to a deferred tax asset; however, only where there are expected to be sufficient future taxable profits to use the loss.

There is no indication of Rhydding's future profitability, although the extent of the current year losses suggests that future profits may not be available. If this is the case then no deferred tax asset should be recognised.

If, however, the current year loss is due to a one-off factor, or there are other reasons why a return to profitability is expected, then the deferred tax asset may be recognised at 20% × £6.5m = £1.3 million.

(2) The intra-group sale gives rise to an unrealised year-end profit of £12m × 20/120 × ½ = £1m. Consolidated profit and inventory are adjusted for this amount.

This profit has, however, already been taxed in the accounts of Burley. A deductible temporary difference therefore arises which will reverse when the goods are sold outside the group and the profit is realised. The resulting deferred tax asset is £1m × 30% = £300,000.

This may be recognised to the extent that it is recoverable.

Answer to Interactive question 10

Implications:

(1)

(a) Fair value adjustments are treated in a similar way to temporary differences on revaluations in the entity's own accounts. A deferred tax liability is recognised under IAS 12 even though the directors have no intention of selling the property, as it will generate taxable income in excess of depreciation allowed for tax purposes. The deferred tax of £1m × 25% = £0.25m is debited to goodwill, reducing the fair value adjustments (and net assets at acquisition) and increasing goodwill.

(b) Provisions for unrealised profits are temporary differences which create deferred tax assets and the deferred tax is provided at the receiving company's rate of tax. A deferred tax asset would arise of (3.6 × 2/6) @30% = £360,000.

(2)

(a) The unrealised gains are temporary differences which will reverse when the investments are sold therefore a deferred tax liability needs to be created of (£8m × 25%) = £2m.

(b) The allowance is a temporary difference which will reverse when the currently unidentified loans go bad and the entity will then be entitled to tax relief. A deferred tax asset of (£2m at 25%) = £500,000 should be created.

(3) No deferred tax liability is required for the additional tax payable of £2 million, as Angelo controls the dividend policy of Escalus and does not intend to remit the earnings to its own tax regime in the foreseeable future.

(4) Angelo's unrelieved trading losses can only be recognised as a deferred tax asset to the extent they are considered to be recoverable. In assessing the recoverability there needs to be evidence that there will be suitable taxable profits from which the losses can be deducted in the future. To the extent Angelo itself has a deferred tax liability for future taxable trading profits (eg, accelerated tax depreciation) then an asset could be recognised.

Answer to Interactive question 11

Investments in foreign branches (or subsidiaries, associates or joint arrangements) are affected by **changes in foreign exchange rates**. In this case, the branch's taxable profits are determined in dinars, and changes in the dinar/pound exchange rate may give rise to temporary differences. These differences can arise where the carrying amounts of the non-monetary assets are translated at historical rates and the tax base of those assets are translated at the closing rate. The **closing rate** may be used to translate the tax base because the resulting figure is an **accurate measure of the amount that will be deductible in future periods. The deferred tax is charged or credited to profit or loss.**

The deferred tax arising will be calculated **using the tax rate in the foreign branch's jurisdiction**, that is **20%.**

	Dinars ('000)	**Exchange rate**	**Pounds £'000**
Property			
Carrying amount: Cost	6,000		1,200
Depreciation for the year	(500)		(100)
Carrying amount	5,500	5	1,100
Tax base: Cost	6,000		
Tax depreciation	(750)		
Carrying amount	5,250	6	875
Temporary difference			225
Property	**Dinars ('000)**	**Exchange rate**	**Pounds £'000**
Deferred tax at 20%			45

The **deferred tax charge in profit or loss will therefore increase by £45,000.**

If the tax base had been translated at the historical rate, the tax base would have been £(5.25m ÷ 5) = £1.05 million. This gives a temporary difference of £1.1m – £1.05m = £50,000, and therefore a deferred tax liability of £50,000 × 20% = £10,000. This is considerably lower than when the closing rate is used.

Answer to Interactive question 12

According to IAS 12, *Income Taxes* the tax expense in the statement of profit or loss and other comprehensive income includes the tax charge for the year, any under or overprovision of income tax from the previous year and any increase or decrease in the deferred tax provision:

	£
Current tax expense	X
Under/overprovisions relating to prior periods	X/(X)
Increases/decreases in the deferred tax balance	X/(X)
	X

While the correction of an over or under provision relates to a prior period, this is **not a prior period adjustment** as defined in IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors* and as assumed by Tacks. Rather, it is a **change in accounting estimate**.

Changes in accounting estimates result from new information or new developments and, accordingly, are **not corrections of errors**. A prior period error, which would require a prior period adjustment is **an omission or misstatement arising from failure to use reliable information** that was available or could have been obtained at the time of the authorisation of the financial statements. This is **not the case here**. Tacks had accounted for all known issues at the previous year end (30 November 20X1), and could not have foreseen that the tax adjustment would be required. No penalties were applied by the taxation authorities, indicating that there were no fundamental errors in the information provided to them. Correction of an over- or under-provision for taxation is routine, since taxation liabilities are difficult to estimate.

The effect of a change in accounting estimate must be **applied by the company prospectively** by including it in profit or loss in the period of change, with separate disclosure of the adjustment in the financial statements.

Answer to Interactive question 13

Journal entries and explanations:

Machinery purchase

The plant is categorised as a non-monetary asset per IAS 21. As such it should be measured at the rate of exchange at the acquisition date of 1 January 20X3. Therefore the plant should originally have been included at cost of Kr12 million (US$30m/2.5) and a liability for that sum recognised too.

Depreciation should be charged over the useful life of the asset, which commences on 1 January, and so only nine months depreciation is required to 30 September 20X3. This gives a depreciation charge of Kr900,000 and a carrying amount of Kr11.1 million.

An exchange difference arises between 1 January and 31 March, when payment is made. This should be charged to the income statement instead of directly to equity.

The correct exchange difference is therefore a loss of Kr500,000 (Kr12.5m – Kr12m).

The relevant correcting journals are:

		Dr Kr million	Cr Kr million
DEBIT	PPE		
	Cost Kr12m – Kr10m	2	
CREDIT	Creditor		2
Being correct recording of cost of the machinery			
DEBIT	Creditor	2.5	
CREDIT	Retained earnings		2.5
Being journal to reverse original exchange difference (Kr12.5m – Kr10m)			
DEBIT	Profit or loss	0.5	
CREDIT	Creditor		0.5
Being correct exchange loss taken to profit or loss			
DEBIT	PPE	0.1	
CREDIT	Profit or loss		0.1
Being correction to depreciation charge (Kr1m – Kr0.9m)			

There are no deferred tax implications as the tax base and the carrying amount are the same.

Impairment

Per IAS 36 the impairment of Kr18 million should initially be offset against the revaluation surplus of Kr16.8 million, and the excess of Kr1.2 million charged in the income statement.

The journal is:

CREDIT	Profit or loss	Kr16.8m	
DEBIT	Revaluation surplus		Kr16.8m

Again there should be no deferred tax implications as the tax base and the carrying amount are the same.

Investment

The investment is classified as held for trading per IFRS because there is an intention to sell the shares at the end of the year. Therefore they should be measured at fair value and the gain/loss taken to the income statement.

At 30 September the increase in fair value is Kr4.8 million, and this is credited to the income statement.

DEBIT	Investments	Kr4.8m	
CREDIT	Profit or loss		Kr4.8m

A deferred tax liability of Kr 960,000 (20% × Kr 4.8m) should be created because the recognition of the increase in fair value represents a taxable temporary difference.

DEBIT	Profit or loss deferred tax	Kr960,000	
CREDIT	Deferred tax provision		Kr960,000

Provision

The provision should initially be based on a figure of Kr10 million per IAS 37, as this is the most likely outcome for the clean-up costs.

However the provision should then be discounted using the pre-tax discount rate of 8% over the 20- year period from 1 October 20X2. The initial provision should therefore be Kr2.145 million.

As the provision relates to the rights, the cost should be added to intangible assets.

The intangible asset should then be amortised in the income statement over the 20 years to when the rights expire.

The provision should be unwound over the period to when the clean-up costs are due.

		Dr	Cr
		Kr million	**Kr million**
DEBIT	Intangible asset	2.145	
DEBIT	Provision Profit or loss	12.855	
CREDIT			15
DEBIT	Profit or loss (Kr10.645m/20)	0.532	
CREDIT	Intangible asset		0.532
DEBIT	Profit or loss (finance costs) (Kr2.145m × 8%)	0.172	
CREDIT	Provision		0.172

Because the clean-up costs are tax deductible, a deferred tax asset should be created for the provision at 30 September 20X3.

The provision is Kr2.317 million (Kr2.145m + 0.172m) and so the deferred tax asset is Kr0.463 million.

		Dr	Cr
		Kr million	**Kr million**
DEBIT	Deferred tax asset	0.463	
CREDIT	Profit or loss		0.463

Adjusted statement of financial position

Statement of financial position at 30 September 20X3

	Draft	Plant	Impair	Invest	Prov'n	Total
	Kr'000	Kr'000	Kr'000	Kr'000	Kr'000	Kr'000
Non-current assets						
Property, plant & equipment	61,600	2,100				63,700
Intangible assets	8,500				1,613	10,113
Financial investments	7,700			4,800		12,500
Deferred tax	0				463	463
	77,800					86,776
Current assets	23,700					23,700
Total assets	101,500					110,476
Equity and liabilities						
Capital and reserves						
Issued Kr 1 shares	10,000					10,000
Retained earnings	42,600	2,100	16,800	3,840	14,759	80,099
Revaluation surplus	16,800		(16,800)			0
	69,400					90,099
Non-current liabilities						
Loans	10,000					10,000
Provisions	15,000				(12,683)	2,317
Deferred tax	0			960		960
Current liabilities	7,100					7,100
Total equity & liabilities	101,500					110,476

Note: The deferred tax asset can be offset against the deferred tax liability if both are due to the same tax authority.

Impairment loss: Gemex

The impairment loss in the financial statements of Gemex **reduces the carrying value** of property, plant and equipment, but is **not allowable for tax**. Therefore the **tax base** of the property, plant and equipment **is different from its carrying value** and there is a **temporary difference**.

Under IAS 36, *Impairment of Assets* the impairment loss is allocated first to goodwill and then to other assets:

	Goodwill	Property, plant and equipment	Total
	£m	£m	£m
Carrying value at 30 September 20X3	1	6.0	7.0
Impairment loss	(1)	(0.8)	(1.8)
	–	5.2	5.2

IAS 12 states that **no deferred tax should be recognised on goodwill** and therefore **only the impairment loss relating to the property, plant and equipment affects the deferred tax position.**

The effect of the impairment loss is as follows:

	Before impairment	After impairment	Difference
	£m	£m	£m
Carrying value	6	5.2	
Tax base	(4)	(4.0)	
Temporary difference	2	1.2	0.8
Tax liability (20%)	0.4	0.24	0.16

Therefore the impairment loss reduces the deferred tax liability by £160,000.

Answers to Self-test questions

1 Torcularis

£nil and £80,000

IAS 12.7 Examples 2 and 3 show that:

- For interest receivables the tax base is nil.
- The tax base for trade receivables is equal to their carrying amount.

2 Situations

(a) Deferred tax liability

'Development costs' lead to a deferred tax liability.

(b) Deferred tax asset

(c) No deferred tax implications

'A penalty payable' has no deferred tax implications.

3 Budapest

Statements:

(1) True

(2) True

Under IAS 12.19 the excess of an asset's fair value over its tax base at the time of a business combination results in a deferred tax liability. As it arises in Lisbon, the tax rate used is 20% and the liability is £800 ((£12,000 – £8,000) × 20%).

The recognition of a deferred tax liability in relation to the initial recognition of goodwill is specifically prohibited by IAS 12.15(a).

4 Dipyrone

£25,250

Under IFRS 10, intra-group profits recognised in inventory are eliminated in full and IAS 12 applied to any temporary differences that result. This profit elimination results in the tax base being higher than the carrying amount, so deductible temporary differences arise. Deferred tax assets are measured by reference to the tax rate applying to the entity who currently owns the inventory.

So the deferred tax asset in respect of Dipyrone's eliminated profit is £14,850 (£600,000 × 25% × 30% × 33% tax rate) and in respect of Reidfurd's eliminated profit is £10,400 (£800,000 × 20% × 25% × 26% tax rate), giving a total of £25,250.

5 Rhenium

£30,000 asset

The year-end accrual is £120,000 (£6m × 8% × 3/12). Because the £120,000 year-end carrying amount of the accrued interest exceeds its nil tax base, under IAS 12.5 there is a deductible temporary difference, of £120,000. Under IAS 12.24 a deferred tax asset must be recognised.

The deferred tax asset is the deductible temporary difference multiplied by the tax rate expected to exist when the tax asset is realised (IAS 12.47). This gives a deferred tax asset of (£120,000 × 25%) =
£30,000.

6 Cacholate

£162,000

Because the £2.16 million year-end carrying amount of the asset exceeds its £1.35 million (£1,500,000 × 18/20) tax base, under IAS 12.5 there is a taxable temporary difference, of £810,000. Under IAS 12.15 a deferred tax liability must be recognised, of £162,000 (£810,000 × 20%). As there was no such liability last year (the carrying amount and the tax base were the same), the charge in the current year is for the amount of the liability.

Because the revaluation surplus is recognised as other comprehensive income and accumulated in equity (IAS 12.62), the deferred tax charge is recognised as tax on other comprehensive income and also accumulated in equity, under IAS 12.61.

7 Spruce

£550,000

A deferred tax asset shall be recognised for the carry forward of unused tax losses to the extent that future taxable profits will be available for offset (IAS 12.34). The loss incurred in the current year is a one-off, and the company has a history of making profits and expects to do so over the next two years. So it is likely that there will be future profits to offset.

£500,000 of the loss will be relieved by carry back, leaving £4,200,000 for carry forward. But the carry forward is limited to the likely future profits, so £2.2 million.

At the 25% tax rate, the deferred tax asset is £550,000.

8 Bananaquit

Statements:

(1) False

(2) False

The deferred tax figure in profit or loss is the difference between the opening and closing deferred tax liabilities. At the start of the year the liability was £450,000 (£1.5m × 30%). The amount of the change is £30,000, but it is a deferred tax credit, not charge to profit or loss.

At the end of the year the £2.4 million carrying amount of the assets exceeds their £1.0 million tax base, so under IAS 12.5 there is a taxable temporary difference, of £1.4 million. Under IAS 12.15 a deferred tax liability (not asset) of £420,000 (£1.4m × 30%) must be recognised.

9 Antpitta

Statements:

(1) False

(2) True

There is an unrealised profit relating to inventories still held within the group, which must be eliminated on consolidation (IFRS 10). But the tax base of the inventories is unchanged, so it is higher than the carrying amount in the consolidated statement of financial position and there is a deductible temporary difference (IAS 12.5).

10 Parea

Deferred tax liability:

(1) £132

(2) £3,743

(3) £349 credit

At 31 December 20X6 the carrying amount of the plant is £30,000 × (1 – 25%) = £22,500, while the tax base is £30,000 × (1 – 27%) = £21,900. The taxable temporary difference is £600 and the deferred tax liability is 22% thereof, £132.

At 31 December 20X7 the carrying amount of the plant is £30,000 × (1 – (25% × 2)) = £15,000, while the tax base is £30,000 × $(1 - 27\%)^2$ = £15,987, leading to a deductible temporary difference of £987. A deferred tax asset should be recognised in relation to this.

Before its revaluation, the property's carrying amount is £40,000 – (5 years at 4%) = £32,000 and the tax base is the same. The revaluation to £50,000 creates a taxable temporary difference of £18,000.

As Parea pays all its tax to a single authority, it must offset deferred tax assets and liabilities (IAS 12.74). At 31 December 20X7 there is a deferred tax liability of £(–987 + 18,000) = £17,013 × 22% = £3,743.

The change in deferred tax liability over the year is £3,743 – £132 = £3,611. Of this, £18,000 × 22% = £3,960 relates to the property revaluation and is recognised in other comprehensive income. This leaves £3,611 – £3,960 = £(349) to be credited to profit or loss (IAS 12.58).

11 XYZ

Liability for deferred tax required by the XYZ Group at 30 November 20X1

	Carrying amount £m	Tax base £m	Temporary differences £m	Rate %	XYZA/ (XYZA) £m
Goodwill (Note 1)	14	–	–		
Subsidiary (Note 1)	76	60	16	25	4
Inventories (Note 2)	24	30	(6)	25	(1.5)
Property, plant and equipment (Note 3)	2,600	1,920	680	30	204
Other temporary differences			90	30	27
Liability for healthcare benefits	(100)	0	(100)	30	(30)
Unrelieved tax losses (Note 4)			(100)	30	(30)
Property sold – tax due 30.11.20X4 (165/30%)			550	30	165
			1,130		*338.5

	£m
Deferred tax liability b/d (given)	280
Deferred tax attributable to subsidiary to goodwill (from above)	4
∴ Deferred tax expense for the year charged to P/L (balance)	54.5
Deferred tax liability c/d (from above)	*338.5
*Deferred tax asset (1.5 + 30 + 30)	(61.5)
Deferred tax liability (balance)	400
	338.5

Notes

1 As no deduction is available for the cost of goodwill in the subsidiary's tax jurisdiction, then the tax base of goodwill is zero. Paragraph 15(a) of IAS 12 states that XYZ Group should not recognise a deferred tax liability of the temporary difference associated with the goodwill. Goodwill will be increased by the amount of the deferred tax liability of the subsidiary ie, £4 million.

2 Unrealised group profit eliminated on consolidation is provided for at the receiving company's rate of tax (ie, at 25%).

3 The tax that would arise if the properties were disposed of at their revalued amounts which was provided at the beginning of the year will be included in the temporary difference arising on the property, plant and equipment at 30 November 20X1.

4 XYZ Group has unrelieved tax losses of £300 million. This will be available for offset against current year's profits (£110m) and against profits for the year ending 30 November 20X2 (£100m). Because of the uncertainty about the availability of taxable profits in 20X3, no deferred tax asset can be recognised for any losses which may be offset against this amount. Therefore, a deferred tax asset may be recognised for the losses to be offset against taxable profits in 20X2. That is £100 million × 30% ie, £30 million.

Comment

The deferred tax liability of XYZ Group will rise in total by £335.5 million (£338.5m – £3m), thus reducing net assets, distributable profits and post-tax earnings. The profit for the year will be reduced by £54.5 million which would probably be substantially more under IAS 12 than the old method of accounting for deferred tax. A prior period adjustment will occur of £280m – £3m as IAS are being applied for the first time (IFRS 1) ie, £277 million. The borrowing position of the company may be affected and the directors may decide to cut dividend payments. However, the amount of any unprovided deferred tax may have been disclosed under the previous GAAP standard used. IAS 12 brings this liability into the statement of financial position but if the bulk of the liability had already been disclosed the impact on the share price should be minimal.

Chapter 23

Financial statement analysis 1

Introduction

Learning topics

Summary

Introduction

Learning outcomes

- Analyse and evaluate the performance, position, liquidity, efficiency and solvency of an entity through the use of ratios and similar forms of analysis including using quantitative and qualitative data
- Compare the performance and position of different entities allowing for inconsistencies in the recognition and measurement criteria in the financial statement information provided
- Evaluate the performance of an entity using accounting information in data analytics software using appropriate data analysis tools, including excel, to interpret and present conclusions
- Construct adjustments to reported earnings in order to determine underlying earnings and compare the performance of an entity over time
- Compare and appraise the significance of accruals basis and cash flow reporting

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
1	**Users and user focus** The annual financial statements provide users with a comprehensive source of financial information about an entity. The financial statements are prepared in a conventionalised way. They provide substantial amounts of narrative and numerical information.	**Approach** So far your financial reporting studies have been focused on preparation of financial statements. The focus of the next two chapters changes to that of users. **Stop and think** From the Corporate Reporting standpoint, the most important users are investors and credit analysts.	The analysis and interpretation of financial statements is a significant portion of the Corporate Reporting examination and could account for approximately 10% of the total marks in an exam if the single-silo FR question is on financial analysis. You would not be asked to list the users in this section, but an understanding of their needs, particularly the needs of investors and credit analysts, should inform your financial analysis.	N/A

<table>
<tr><th>Topic</th><th>Practical significance</th><th>Study approach</th><th>Exam approach</th><th>Interactive Questions</th></tr>
<tr><td>2</td><td>Accounting ratios and relationships
A key skill is to be able to analyse the information the financial statements provide so that past performance can be analysed and future performance predicted.
In this section we look at the main accounting ratios and relationships that are important to users.</td><td>Approach
Make sure you understand the purpose of and can calculate ratios relating to:
• Performance
• Short-term liquidity
• Long-term solvency
• Efficiency (asset and working capital)
• Investors' (or stock market) ratios
Stop and think
Why should caution be exercised when using the current and quick ratios?</td><td>Questions will not give you a list of ratios to calculate. You may, as part of a longer scenario question, be required to analyse the performance of a potential acquisition target.
You will probably be required to make adjustments to the figures, correcting the accounting treatment, before going on to do the analysis.</td><td>IQ1 to 5
You should answer all these interactive questions. They are very short, and cover the main accounting ratios.</td></tr>
<tr><td>3</td><td>Statements of cash flows and their interpretation
While most ratios follow accruals-based accounting, cash flow ratios are important too. This is because many businesses fail through lack of cash rather than lack of profits.</td><td>Approach
Pay particular attention to cash from operating activities. If this is significantly lower than profit, this may indicate liquidity problems.
Read through the paragraphs on the other cash flows, paying attention to which cash flows are discretionary and which are not.
Stop and think
Equity dividends paid are discretionary in theory, but in practice there may be considerable pressure to pay them.</td><td>The context where you might meet cash flow ratios could be a report to a bank as part of an application for a loan, as was required in a recent exam question.</td><td>IQ10: Calculation of cash flow ratios
The title is self-explanatory – you are given a statement of cash flows and required to calculate six cash flow ratios.</td></tr>
</table>

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
4	**Economic events** It is important in interpretation scenarios to take account of both economic factors affecting all businesses and the specific industry the business is operating in.	**Approach** This is a short section about the wider economic environment. **Stop and think** When considering the current state of the economy, the impact of the Covid- 19 pandemic will be considerable.	A financial analysis question might involve using IFRS 8, *Operating Segments*, which you met in an earlier chapter.	N/A
5	**Business issues** You may need to calculate a range of ratios and to provide some explanation for their movements from previous periods or their comparability to industry averages.	**Approach** The key point of this section is to compare like with like. If a business diversifies or acquires or disposes of a subsidiary, then year-on-year comparisons will be less meaningful. **Stop and think** Sometimes the figures need to be adjusted for the effect of a change to make them comparable.	An exam question might ask you to analyse the impact of an acquisition on key performance targets for the current and future year, as happened a few years ago.	**IQ11: The effect of business issues on financial reporting** Though shorter than an exam question, this is a useful exercise to get you thinking as you have to pick the IFRS® Standard yourself. Your answer may differ from the one in the chapter, but you would still get credit in an exam if you backed up your choice.
6	**Accounting choices** Management may be influenced in their choice of accounting policies and the judgement they make in determining accounting estimates by the way the information may affect a user's view of the business.	**Approach** There is not as much choice as there once was; choice is limited to three different areas: • Asset revaluation • Cost or fair value model for investment properties • Classification of financial assets	You may get an ethical dilemma, where an audit client wishes to change accounting policy in order to make the figures look better rather than because it provides more relevant and reliable information.	**IQ12: Asset revaluation** This question illustrates the impact on reported results and net assets of a choice to revalue.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
		Stop and think How might different accounting policies affect the interpretation of financial statements?		
7	**Ethical issues** Ethical issues are an important part of the Corporate Reporting syllabus, as seen in the previous section.	**Approach** Look carefully at the reasons why management might try to improve the appearance of the financial information, and how they might try to do it. **Stop and think** What is meant by professional scepticism?	Ethical dilemmas may arise in an auditing context, where a client is motivated by a bonus to overstate profits.	**IQ13: Changing payment dates** Ethical issues are generally tested by narrative questions, but this one is numerical, and shows how the figures can be manipulated. **IQ14: Ethical pressures** This is a more typical question presenting several ethical dilemmas.
8	**Industry analysis** Analytical skills are essential in a wide range of work areas from audit planning to desk-top analysis of competitors and acquisition targets.	**Approach** This section is concerned with practical examples of specific industries. **Stop and think** Can you think of others?	Exam questions are set in a wide variety of industries. While specialised knowledge of any particular industry is not required, it does no harm to read the financial press and think about how they vary and why key performance indicators for one industry might not work for another.	N/A
9	**Non-financial performance measures** Non-financial performance measures, for example, sales volume, market share or target delivery times, are important	**Approach** Read through all of this section. **Stop and think** Increasingly companies provide information about environmental or diversity targets.	Non-financial performance measures are not tested as frequently as financial performance measures. However, they were examined in Question 1 in	N/A

CHAPTER 23

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
	and ultimately feed into financial performance.		November 2015 and 2019.	
10	**Limitations of ratios and financial statement analysis** It is important that you understand the limitations of ratio analysis.	**Approach** Read through this list and reflect on how the various issues covered in this chapter will impact upon how you interpret financial information. **Stop and think** Despite increasingly specific IFRS, there is still scope for interpretation and 'creative accounting', which we look at in the next Chapter.	You are more likely to be asked to explain the limitations of a specific financial analysis than in general terms.	N/A

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Users and user focus

Section overview

- Different groups of users of financial statements will have different information needs.
- The focus of an investigation of a business will be different for each user group.

1.1 Information needs

You have covered external users and their information needs in your Professional Level studies and they were touched on again in earlier Chapters of this Workbook. The following table summarises the main groups of users of financial statements and the information they need.

Users	Need information to:
Present and potential investors	Make investment decisions, therefore need information on the following: • Risk and return on investment • Ability of entity to pay dividends
Employees	• Assess their employer's stability and profitability • Assess their employer's ability to provide remuneration, employment opportunities and retirement and other benefits
Lenders	Assess whether loans will be repaid, and related interest will be paid, when due
Suppliers and other trade creditors	Assess the likelihood of being paid when due
Customers	• Assess whether the entity will continue in existence – important where customers have a long-term involvement with, or are dependent on, the entity, for example where there are product warranties or where specialist parts may be needed • Assess whether business practices are ethical
Governments and their agencies	• Assess allocation of resources and, therefore, activities of entities • Help with regulating activities • Assess taxation • Provide a basis for national statistics
The public	Assess trends and recent developments in the entity's prosperity and its activities – important where the entity makes a substantial contribution to a local economy, for example by providing employment and using local suppliers

An entity's management also needs to understand and interpret financial information, both as a basis for making management decisions and also to help in understanding how external users might react to the information in the financial statements.

1.2 User focus

The primary focus of users of the financial statements differs according to their interests. Examples are as follows:

(a) Customers and suppliers are most interested in current liquidity, but also focus on overall pre-tax profitability and net worth of the business in their evaluation of likely future liquidity.

(b) Lenders focus on liquidity, longer-term solvency and ability to service and repay debts.

(c) Shareholders' main concern is with risk and return. They therefore focus mainly on gearing and dividend cover to measure the risk, and on post-tax returns and the overall net worth of the business to measure return. However, they are also interested in solvency, as they will be the first to lose out in the event that the company runs into financial difficulties. Finally, shareholders are interested in liquidity, as this affects the security of their dividends.

1.3 User focus: Corporate Reporting

We will consider all types of users in our studies of financial analysis. However, in the context of Corporate Reporting, the main standpoints are those of:

- investor (or potential investor)
- credit analyst

1.3.1 Investor

An investor uses financial analysis to determine whether an entity is stable, solvent, liquid, or profitable enough to be invested in. When looking at a specific company, the financial analyst will often focus on the statement of profit or loss and other comprehensive income, the statement of financial position and the statement of cash flows.

In addition, certain accounting ratios are more relevant to investors than to other users. These are discussed in section 2.7.

One key area of financial analysis involves extrapolating the company's past performance into an estimate of the company's future performance.

1.3.2 Credit analyst

A credit analyst may have a similar perspective to a lender, although he/she may be advising a lender rather than doing the lending. As the name suggests, credit analysts are experts in evaluating the creditworthiness of individuals and businesses. They determine the likelihood that a borrower will be able to meet financial obligations and pay back a loan, often by reviewing the borrower's financial history and determining whether market conditions will be conducive to repayment.

Credit analysts are likely to use ratios, including cash flow ratios (see section 3.2) when reviewing the financial history of a potential borrower. They focus on determining whether the borrower will have sufficient cash flows by comparing ratios to industry standards, other borrowers and historical trends.

Professional skills focus: Concluding, recommending and communicating

Information needs to be tailored to the user. If information is provided that is not relevant to the user's needs, it can obscure the information that is relevant.

1.4 Financial position and performance

Different users usually require different information. However, there is overlap, as all potential users are interested in the financial performance and financial position of the company as a whole.

The next section examines how accounting ratios can be used to help assess financial performance and position. The additional perspective provided by analysis of the statement of cash flows is covered later in this chapter.

2 Accounting ratios and relationships

Section overview

- Ratios are commonly classified into different groups according to the focus of the investigation.
- Ratios can help in assessing performance, short-term liquidity, long-term solvency, efficiency and investor returns.

2.1 Introduction to ratios

Accounting ratios help to summarise and present financial information in a more understandable form. They help with assessing the performance of a business by identifying significant relationships between different figures. The term 'accounting ratios' is used loosely, to cover the outcome of different types of calculation; some ratios measure one amount as a ratio of another (such as 2:1) whereas others measure it as a percentage of the other (such as 200%).

Ratios are of no use in isolation. To be useful, a basis for comparison is needed, such as the following:

- Previous years
- Other companies
- Industry averages
- Budgeted or forecast vs actual

Ratios do not provide answers but help to focus attention on important areas, therefore minimising the chance of failing to identify a significant trend or weakness.

Ratios divide into the following main areas:

- Performance
- Short-term liquidity
- Long-term solvency
- Efficiency (asset and working capital)
- Investors' (or stock market) ratios

2.1.1 Which figures to use?

Many accounting ratios are calculated using one figure from the statement of profit or loss and other comprehensive income (which covers a period of time, usually a year) and one from the statement of financial position (which is a snapshot at a point in time, usually the year end). The result may be distorted if the statement of financial position (snapshot) amounts are not typical of the amounts throughout the period covered by the statement of profit or loss and other comprehensive income.

Consider a toy retailer with a 31 December year end: over half its annual sales may well be made in the three months leading up to Christmas, while its inventory levels at 31 December will probably be at their lowest point throughout the year, and certainly much lower than at their highest point which might be some time in October in the run up to Christmas. To calculate a relationship between cost of sales for 12 months and the 31 December level of inventories and then use it as a measure of management's efficiency in managing inventory levels (as does the inventory turnover ratio in section 2.5.2 below) runs the risk of a major distortion. The calculation should really be done using the statement of profit or loss and other comprehensive income amount and the average inventory holding throughout the year, calculating the average every month or more frequently.

But monthly statement of financial position amounts are not made available to financial statement users. Sometimes half-yearly (or quarterly) statements of financial position are published, in which case they may well result in useful averages. But averaging the amounts at the current year end and the previous year end may well be no better than just using current year-end amounts, since the result may only be to average two unrepresentative amounts.

Professional skills focus: Assimilating and using information

In approaching financial analysis questions, and interpretation of financial statements in real life, you will be faced with a great deal of information. It is particularly important to sift out the key information – for example, a company that is expanding may benefit from analysis of ratios relating to cash flow.

2.2 Performance

2.2.1 Significance

Performance ratios measure the rate of return earned on capital employed, and analyse this into profit margins and use of assets. These ratios are frequently used as the basis for assessing management effectiveness in utilising the resources under their control.

2.2.2 Key ratios

Return on capital employed (ROCE)

This measures the overall efficiency of a company in employing the resources available to it; that is, its capital employed.

(Return ÷ Capital employed) × 100 (Source: SPLOCI ÷ Source: SFP)

where: Return = profit before interest and tax (PBIT) + associates' post-tax earnings

Capital employed = equity + net debt, where net debt = interest-bearing debt (non-current and current) minus cash and cash equivalents

Remember:

- Equity includes irredeemable preference shares and the non-controlling interests.
- Net debt includes redeemable preference shares.

Many different versions of this ratio are used but all are based on the same idea: identify the long- term resources available to a company's management and then measure the financial return earned on those resources.

In the version used in this Workbook, the total resources available to a company are the amounts owed to shareholders who receive dividends, plus the amounts owed to those who provide finance only on the condition that they receive interest in return. So interest-bearing debt, both long term and short term (for example bank overdrafts), are included but trade payables (which are an interest- free source of finance) are not. But to cope with companies which move from one month to another between positive and overdrawn bank balances, holdings of cash and cash equivalents (but not any other 'cash' current assets which management does not describe as cash equivalents) are netted off, to arrive at 'net debt'.

The return is the amount earned before deducting any payments to those who provide the capital employed. So it is the profits before both dividends and interest payable. Because interest is tax- deductible, the profit figure is also before taxation. The PBIT (profit before interest and tax) tag is well established term which is used in ratio calculations although in the statement of profit or loss and other comprehensive income layout used in this Workbook the description given to this figure is 'profit/(loss) from operations'.

To allow valid comparisons to be made with other companies, the return must also include the earnings from investments in associates, because some groups carry out large parts of their activities through associates, rather than the parent or subsidiaries.

Strictly speaking, it is the associates' pre-tax earnings which should be included, but under IAS 28 only the post-tax amount is shown. In practice, some users adjust this figure using an estimated tax rate for the associates to establish a pre-tax return.

Like profit, capital employed is affected by the accounting policies chosen by a company. For example, a company that revalues its PPE will have higher capital employed than one which does not. The depreciation expense will be higher and profits will be reduced as a result of the policy. The accounting adjustments will reduce ROCE.

Return on shareholders' funds (ROSF)

This measures how effectively a company is employing funds that parent company shareholders have provided.

Profit attributable to owners of a parent ÷ Equity minus non-controlling interest (Source:

SPLOCI ÷ Source: SFP)

It is the return on the funds provided by the parent company's shareholders that is being analysed here, so it is their equity which goes on the bottom of the fraction. This is the equity used in the ROCE calculation minus the non-controlling interest.

The return is the profit for the year attributable to those shareholders.

Analysis usually focuses on ROCE, as opposed to ROSF, because the issue is management's ability to generate return from overall resources rather than how those resources are financed.

CHAPTER 23

Worked example: Calculating ROCE and ROSF

Consider two companies without subsidiaries in the same industry with different capital structures:

	Company 1	Company 2
	£m	£m
Statement of financial position		
Equity (A)	80	20
Loans at 10%	20	80
Capital employed (B)	100	100

Statement of profit or loss and other comprehensive income

PBIT (C)	20	20
Loan interest at 10%	(2)	(8)
Profit before tax	18	12
Tax at 30%	(5)	(4)
Profit after tax (for owners) (D)	13	8

Solution ROCE/ROSF

		Company 1	Company 2
		%	%
ROCE	(C) as % of (B)	20	20
ROSF	(D) as % of (A)	16	40

ROCE is the same, so the companies are equally good in generating profits. But with different capital structures, ROSF is very different.

If it wished, Company 1 could achieve the same capital structure (and therefore the same ROSF) by borrowing £60 million and using it to repay shareholders.

It is often easier to change capital structures than to change a company's ability to generate profits. Hence the focus on ROCE.

Note that Company 2 has much higher gearing and lower interest cover (these ratios are covered later in this chapter).

Interactive question 1: ROCE and ROSF

Name five considerations that you should consider when drawing conclusions from ROCE and ROSF calculations.

ROCE and ROSF

(1)	
(2)	
(3)	
(4)	
(5)	

See **Answer** at the end of this chapter.

Gross profit percentage/margin

This measures the margin earned by a company on revenue, before taking account of overhead costs.

(Gross profits ÷ revenue) × 100 (Source: SPLOCI ÷ Source: SPLOCI)

Interactive question 2: Gross profit percentage

List four possible reasons for changes in the year-on-year gross profit percentage.

Gross profit percentage

(1)	
(2)	
(3)	
(4)	

See **Answer** at the end of this chapter.

Operating cost percentage

This measures the relationship of overheads (fixed and variable, which usually comprise distribution costs and administrative expenses) to revenue.

(Operating costs/overheads ÷ Revenue) × 100 (Source: SPLOCI ÷ Source: SPLOCI)

Ideally this should be broken into variable overheads (expected to change with revenue) and fixed overheads. However, such information is not usually published in financial statements.

Interactive question 3: Operating cost percentage

List two considerations that could account for changes in the operating cost percentage.

Operating cost percentage

(1)	
(2)	

See **Answer** at the end of this chapter.

Operating profit margin/net margin

This shows the profit margin after all operating expenses.

(PBIT ÷ Revenue) × 100 or (Profit from operations ÷ Revenue) × 100 (Source: SPLOCI ÷ Source: SPLOCI)

2.2.3 Commentary

ROCE measures the return achieved by management from assets that they control, before payments to providers of financing for those assets (lenders and shareholders).

For companies without associates, ROCE can be further subdivided into net profit margin and asset turnover (use of assets).

(Net profit margin × Net asset turnover) = ROCE

(PBIT ÷ Revenue) × (Revenue ÷ Capital employed) = (PBIT ÷ Capital employed)

(Source: SPLOCI ÷ Source: SPLOCI), (Source: SPLOCI ÷ Source: SFP), (Source: SPLOCI ÷ Source: SFP) This subdivision is useful when comparing a company's performance from one period to another.

While ROCE might be identical for the two periods, there might be compensating changes in the two components; that is, an improvement in margin might be offset by a deterioration in asset utilisation. The subdivision might be equally useful when comparing the performance of two companies in the same period.

Although associates' earnings are omitted, it will probably be worth making this subdivision even for groups with earnings from associates, unless those earnings are very substantial indeed.

Net profit margin is often seen as a measure of quality of profits. A high profit margin indicates a high profit on each unit sold. This ratio can be used as a measure of the risk in the business, since a high margin business may remain profitable after a fall in margin while a low margin business may not.

Context example: Net profit margin

Two companies with a revenue of £200 have net profit margins of 30% and 4%. If each company discounts their sale prices by 5%, compute revised net profit margins.

	Base	5% price discount	Revised
Company 1	**£**	**£**	**£**
Revenue	200	(10)	190
Costs	(140)		(140)
Profit	60	(10)	50
Net profit margin	30%		26%
	Base	**5% price discount**	**Revised**
Company 2	**£**	**£**	**£**
Revenue	200	(10)	190
Costs	(192)		(192)
Profit	8	(10)	(2)
Net profit margin	4%		–1%

By contrast, net asset turnover (considered further under efficiency ratios in section 2.5.2 below) is often seen as a quantitative measure, indicating how intensively the management is using the assets.

A trade-off often exists between margin and net asset turnover. Low margin businesses, for example food retailers, usually have high asset turnover. Conversely, capital-intensive manufacturing industries usually have relatively low asset turnover but higher margins, for example electrical equipment manufacturers.

Gross profit is useful for comparing the profitability of different companies in the same sector but less useful across different types of business, as the split of costs between cost of sales and other expense headings varies widely according to the nature of the business. Even within companies competing within the same industry distortions can be caused if companies allocate individual costs to different cost headings.

Particular care must be taken when calculating, and then considering the implications of, these ratios if the company concerned is presenting both continuing and discontinued operations. In the statement of profit or loss and other comprehensive income layout used in this Workbook, the amounts for revenue, gross profit, operating costs and profit from operations all relate to continuing operations only. Although amounts relating to the discontinued operations' revenue, total costs and profit from operations are made available in the notes, it is probably not worth adding them back into the continuing operations' amounts, for the simple reason that the results of continuing operations form the most appropriate base on which to project future performance.

2.3 Short-term liquidity

2.3.1 Significance

Short-term liquidity ratios are used to assess a company's ability to meet payments when due. In practice, information contained in the statement of cash flows is often more useful when analysing liquidity.

2.3.2 Key ratios

Current ratio

This measures the adequacy of current assets to cover current liabilities. (Current assets ÷ Current liabilities) (usually expressed as X:1)

(Source: SFP ÷ Source: SFP)

Quick (acid test or liquidity) ratio

Inventories, often rather slow moving, are eliminated from current assets, giving a better measure of short-term liquidity. This is appropriate for those types of business that take significant time to convert inventories into cash, such as an aircraft manufacturer.

((Current assets – inventories) ÷ Current liabilities) (usually expressed as X:1) (Source: SFP ÷ Source: SFP)

Interactive question 4: Current and quick ratios

Suggest a conclusion that may be drawn from high and low current and quick ratios.

What factors should be considered when investigating changes in short-term liquidity ratios?

See **Answer** at the end of this chapter.

2.3.3 Commentary

The current ratio is of limited use as some current assets, for example inventories, may not be readily convertible into cash, other than at a large discount. Hence, this ratio may not indicate whether or not the company can pay its debts as they fall due.

As the quick ratio omits inventories, this is a better indicator of liquidity but is subject to distortions. For example, retailers have few trade receivables and use cash from sales quickly, but finance their inventories from trade payables. Hence, their quick ratios are usually low, but this is in itself no cause for concern.

A high current or quick ratio may be due to a company having excessive amounts of cash or short- term investments. Though these resources are highly liquid, the trade-off for this liquidity is usually a low return. Hence, companies with excessive cash balances may benefit from using them to repay longer-term debt or invest in non-current assets to improve their overall returns.

Therefore, both the current and quick ratios should be treated with caution and should be read in conjunction with other information, such as efficiency ratios and cash flow information.

In the statement of financial position layout used in this Workbook, any non-current assets held for sale will be presented immediately below the subtotal for current assets. In classifying them as held for sale, the company is intending to realise them for cash, so it will usually be appropriate to combine this amount with current assets when calculating both the current and quick ratios.

2.4 Long-term solvency

2.4.1 Significance

Gearing ratios examine the financing structure of a business. They indicate to shareholders and lenders the degree of risk attached to the company and the sensitivity of earnings and dividends to changes in profitability level.

2.4.2 Key ratios

Gearing ratio

Gearing measures the relationship between a company's borrowings and its risk capital. (Net debt (per ROCE) ÷ Equity (per ROCE)) × 100

(Source: SFP ÷ Source: SFP)

Alternatively, the ratio may be computed as follows:

(Net debt ÷ (Net debt + Equity)) × 100

Context example: Gearing

The following are the summarised statements of financial position for two companies. Calculate the gearing ratios and comment on each.

	Company 1	Company 2
	£m	£m
Non-current assets	7	18
Inventory	3	3
Trade receivables	4	3
Cash	1	2
	15	26
Equity	10	10
Trade payables	3	4
Borrowings	2	12
	15	26
Gearing = Net debt ÷ Equity	10% ((2 – 1) ÷ 10)	100% ((12 – 2) ÷ 10)

Both companies have the same equity amount. Company 1 is lower risk, as its borrowings are lower relative to equity. This is because interest on borrowings and capital repayments of debt **must** be paid, with potentially serious repercussions if they are not. Dividend payments on equity instruments are an optional cash outflow for a business.

Company 2 has a high level of financial risk. If the borrowings were secured on the non-current assets, then the assets available to shareholders in the event of a winding up are limited.

Interactive question 5: Gearing

When drawing conclusions from gearing ratios suggest two matters that should be considered.

Gearing

(1)	
(2)	

See **Answer** at the end of this chapter.

Interest cover

Profit before interest payable (ie, PBIT + investment income) ÷ Interest payable (Source: SPLOCI ÷ Source: SPLOCI)
In calculating this ratio, it is standard practice to add back into interest any interest capitalised during the period.

2.4.3 Commentary

Many different measures of gearing are used in practice, so it is especially important that the ratios used are defined.

Note that under IAS 32, *Financial Instruments: Presentation* redeemable preference shares should be included in liabilities (non-current or current, depending on when they fall due for redemption), while the dividends on these shares should be included in the finance cost/interest payable.

It is also the case that IAS 32 requires compound financial instruments, such as convertible loans, to be split into their components for accounting purposes. This process allocates some of such loans to equity.

Notes

1. Interest on debt capital generally must be paid irrespective of whether profits are earned – this may cause a liquidity crisis if a company is unable to meet its debt capital obligations.
2. Loan capital is usually secured on assets, most commonly non-current assets – these should be suitable for the purpose (not fast-depreciating or subject to rapid changes in demand and price).

High gearing usually indicates increased risk for shareholders as, if profits fall, debts will still need to be financed, leaving much smaller profits available to shareholders. Highly geared businesses are therefore more exposed to insolvency in an economic downturn. However, returns to shareholders will grow proportionately more in highly geared businesses where profits are growing.

The gearing ratio is significantly affected by accounting policies adopted, particularly the revaluation of PPE. An upward revaluation will increase equity and capital employed. Consequently it will reduce gearing.

Context example: Impact of gearing on earnings

A company has an annual profit before interest of £200. Its interest on non-current debt is fixed at £100 per annum.

Consider the effects on net profits if the profits before interest were to decrease or increase by £100 per annum.

	(1)	(2)	(3)
	£	£	£
Profit before interest	200	100	300
Interest on non-current debt	(100)	(100)	(100)
Profit available to shareholders (earnings)	100	–	200
Compared to situation (1):			
Change in profits before interest		–50%	+50%
Change in earnings		–100%	+100%

Note: The above example could benefit from using excel, particularly if more figures were involved which did not change.

Low gearing provides scope to increase borrowings when potentially profitable projects are available. Low-geared companies will usually be able to borrow more easily and cheaply than already highly geared companies.

However, gearing can be too low. Equity finance is often more expensive in the long run than debt finance, because equity is usually seen as being more risky. Therefore an ungeared company may benefit from adjusting its financing to include some (usually cheaper) debt, thus reducing its overall cost of capital.

Gearing is also significant to lenders, as they are likely to charge higher interest, and be less willing to lend, to companies which are already highly geared, due to the increased default risk.

Interest payments are allowable for tax purposes, whereas dividends are not. This is another attraction of debt.

Interest cover indicates the ability of a company to pay interest out of profits generated. Relatively low interest cover indicates that a company may have difficulty financing the running costs of its debts if its profits fall, and also indicates to shareholders that their dividends are at risk, as interest must be paid first, even if profits fall.

2.5 Efficiency

2.5.1 Significance

Asset turnover and the working capital ratios are important indicators of management's effectiveness in running the business efficiently, as for a given level of activity it is most profitable to minimise the level of overall capital employed and the working capital employed in the business.

2.5.2 Key ratios

Net asset turnover

This measures the efficiency of revenue generation in relation to the overall resources of the business. As the amount of net assets equals the amount of capital employed and as capital employed is used in the ROCE calculation, it is easiest to calculate net asset turnover as:

Revenue ÷ Capital employed (Source: SPLOCI ÷ Source: SFP)

Note that net asset turnover can be further subdivided by separating out the non-current asset element to give non-current asset turnover:

Revenue ÷ Non-current assets (Source: SPLOCI ÷ Source: SFP)

This relates the revenue to the non-current assets employed in producing that revenue.

Asset turnover is sometimes known as 'sweating the assets'. It is a reference to management's ability to maximise the output from each £ of capital that the company uses within the business.

Inventory turnover

The inventory turnover ratio measures the efficiency of managing inventory levels relative to demand. A business needs inventory to meet the needs of customers, but inventories are not generating revenues until they are physically sold, and tie up capital during this period. Like all management decisions, a delicate path has to be followed between keeping too much and too little inventory.

Cost of sales ÷ Inventories (Source: SPLOCI ÷ Source: SFP)
(= number of times inventories are turned over each year – usually the higher the better) or
(Inventories ÷ Cost of sales) × 365

(= number of days on average that an item is in inventories before it is sold – usually the lower the better)

Ideally the three components of inventories should be considered separately:

- Raw material to volume of purchases
- WIP to cost of production
- Finished goods to cost of sales

Interactive question 6: Inventory turnover

State two implications of high and low inventory turnover rates.

Inventory turnover

(1)	
(2)	

See **Answer** at the end of this chapter.

Professional skills focus: Applying judgement

Judgement is needed in deciding which ratios to calculate and also to understand their implications. As well as the industry in which the business operates, there are other factors such as the state of the economy which may make comparisons difficult.

Trade receivables collection period

This measures in days the period of credit taken by the company's customers. (Trade receivables ÷ Revenue) × 365

(Source: SFP ÷ Source: SPLOCI)

To obtain a full picture of receivables collection, it is best to exclude from the revenue figure any cash sales, since they do not generate receivables. This may be difficult, because published financial statements do not distinguish between cash and credit sales. Strictly speaking, VAT should be removed from receivables (revenue excludes VAT), but such adjustments are rarely made in practice.

Interactive question 7: Trade receivables collection period Suggest three matters that a change in the ratio could indicate. **Trade receivables collection period**

(1)	
(2)	
(3)	

See **Answer** at the end of this chapter.

Trade payables payment period

This measures the number of days' credit taken by the company from suppliers. (Trade payables ÷ Credit purchases) × 365

(Source: SFP ÷ Source: SPLOCI)

This should be broadly similar to the trade receivables collection period, where a business makes most sales and most purchases on credit. If no figures are available for credit purchases, use cost of sales.

Interactive question 8: Trade payables payment period

Suggest two matters that a high and increasing trade payables payment period may indicate.

Trade payables payment period

(1)	
(2)	

See **Answer** at the end of this chapter.

Working capital cycle/cash operating cycle

These last three ratios are often brought together in the working capital cycle (alternatively the cash operating cycle), calculated as inventory days plus trade receivables collection period minus trade payables payment period.

Any increase in the total working capital cycle may indicate inefficient management of the components of working capital.

2.5.3 Commentary

Net asset turnover enables useful comparisons to be made between businesses in terms of the extent to which they work their assets hard in the generation of revenue.

Inventory turnover, trade receivables collection period and trade payables payment period give an indication of whether a business is able to generate cash as fast as it uses it. They also provide useful comparisons between businesses, for example on effectiveness in collecting debts and controlling inventory levels.

Efficiency ratios are often an indicator of looming liquidity problems or loss of management control. For example, an increase in the trade receivables collection period may indicate loss of credit control. Declining inventory turnover may suggest poor buying decisions or misjudgement of the market. An increasing trade payables payment period suggests that the company may be having difficulty paying its suppliers; if they withdraw credit, a collapse may be precipitated by the lack of new supplies.

If an expanding business has a positive working capital cycle, it will need to fund this extra capital requirement, from retained earnings, an equity issue or increased borrowings. If a business has a negative working capital cycle, its suppliers are effectively providing funding on an interest-free basis.

As with all ratios, care is needed in interpreting efficiency ratios. For example, an increasing trade payables payment period may indicate that the company is making better use of its available credit facilities by taking trade credit where available. Therefore, efficiency ratios should be considered together with solvency and cash flow information.

2.6 Non-current asset analysis

Analysts of financial statements use the information provided to understand future performance. For capital-intensive companies it is essential that they understand the capital expenditure policies and efficiency of non-current assets.

2.6.1 Capital expenditure to depreciation

Capital expenditure (additions) ÷ Depreciation

This ratio highlights whether a company is expanding its non-current assets. A ratio below one would indicate that it is not even maintaining its operating capacity. A ratio in excess of one would indicate that the company is expanding operating capacity. But PPE price changes should be taken into account: if they are rising, a ratio of more than one may still indicate a reduction in capacity, unless significant operating efficiencies are being generated from the new assets.

This ratio should include all additions, including those acquired under leases.

It is often helpful to review this ratio over a number of years to identify trends. In the short-term, capital expenditure can be discretionary.

2.6.2 Ageing of non-current assets

Accumulated depreciation ÷ Gross carrying amount of non-current assets

This ratio identifies the proportion of the useful life of PPE that has expired. It should be calculated for each class of PPE. It helps identify:

- assets that are nearing the end of their useful life that may be operating less efficiently or may require significant maintenance; and
- the need to invest in new PPE in the near term.

Obviously both of these ratios are influenced by the depreciation policies adopted by management.

Worked example: Capital expenditure

The following is an extract from the financial statements of Raport Ltd for the year ended 31 December 20X4.

Note 1	**Plant and equipment**
	£'000
Cost	
At 1 January 20X4	2,757
Additions	137
Disposals	(94)
At 31 December 20X4	2,800
Accumulated depreciation	
At 1 January 20X4	1,922
Depreciation	302
Disposals	(60)
At 31 December 20X4	2,164
Carrying amount 1 January 20X4	835
Carrying amount 31 December 20X4	636

Note 2	**20X4**	**20X3**
	£'000	**£'000**
Profit from operations is stated after charging		
Depreciation	302	289
Loss on disposal of plant and equipment	25	32

Requirement

Provide an analysis of the plant and equipment of Raport Ltd.

Solution

Analysis as follows:

- Capital expenditure represents 45% ((137 ÷ 302) × 100%) of the depreciation expense for the year. This suggests that management is not maintaining capacity.
- Accumulated depreciation represents 77% ((2,164 ÷ 2,800) × 100%) of the cost of the assets.

This has increased from 70% ((1,922 ÷ 2,757) × 100%) in the previous year.

This confirms that plant and equipment is ageing without replacement. On average the plant and equipment is entering the last quarter of its useful life. This could indicate that the plant is becoming less efficient.

- The accounting policies should be reviewed, because the losses on disposal could indicate that depreciation rates are too low and that useful lives have been overestimated. This would confirm that the plant and equipment is aged and raise further concerns about its renewal and efficiency.

2.7 Investors' ratios

2.7.1 Significance

Different investors' ratios (also known as stock market ratios) help different investors:

- Price/earnings ratio will be important to those investors looking for capital growth.
- Dividend yield, dividend cover and dividends per share will be important to those investors seeking income.

Because all economic decisions relate to the future, not the past, investors should ideally use forecast information. In practice only historical figures are usually available from financial statements, but investment analysts devote substantial amounts of time to making estimates of future earnings and dividends which they publish to their clients.

Investors' ratios are only meaningful for quoted companies as they usually relate, directly or indirectly, to the share price.

2.7.2 Key ratios

Dividend yield

(Dividend per share ÷ Current market price per share) × 100

The market price per share is a forward-looking value, since a buyer of a share buys into the future, not past, performance of the company. So the most up to date amount for the dividend per share needs to be used; using information in financial statements, the total dividend will be the interim for the year recognised in the statement of changes in equity plus the final for the year disclosed in the notes to the accounts.

Dividend yield may be more influenced by dividend policy than by financial performance. A high yield based on recent dividends and the current share price may come about because the share price has fallen in anticipation of a future dividend cut. Rapidly growing companies may exhibit low yields based on historical dividends, especially if the current share price reflects anticipated future growth, because such companies often retain cash in the business, through low dividends, to finance that growth.

Dividend cover

Earnings per share ÷ Dividend per share

A quoted company is required by IAS 33, *Earnings per Share* to disclose an amount for its earnings per share (EPS).

The dividend cover ratio shows the extent to which a current dividend is covered by current earnings. It is an indication of how secure dividends are, because a dividend cover of less than one indicates that the company is relying to some extent on its retained profits, a policy that is not sustainable in the long term.

Price/earnings (P/E) ratio

Current market price per share ÷ Earnings per share

The P/E ratio is used to indicate whether shares appear expensive or cheap in terms of how many years of current earnings investors are prepared to pay for. The P/E ratio is often used to compare companies within a sector, and is published widely in the financial press for this purpose.

A high P/E ratio calculated on historical earnings usually indicates that investors expect significant future earnings growth and hence are prepared to pay a large multiple of historical earnings. (Remember that the share price takes into account market expectations of **future** profits, whereas EPS is based on **past** levels of profit.) Low P/E ratios often indicate that investors consider growth prospects to be poor.

Net asset value

Net assets (equity attributable to owners of parent company) ÷ Number of ordinary shares in issue.

This calculation results in an approximation to the amount shareholders would receive if the company were put into liquidation and all the assets were realised for, and all the liabilities were paid off at, their statement of financial position amounts. In theory it is the amount below which the share price should never fall because, if it did, someone would acquire all the shares, liquidate the company and take a profit through distributions totalling the net asset value.

But the statement of financial position does not measure non-current assets at realisable value (many would sell for less than their carrying amount but some, such as freehold and leasehold properties, might realise more) and additional liabilities, such as staff redundancy payments and liquidation fees, would need to be recognised. But there might be cash inflows on liquidation relating to items such as intangible assets, which can be sold but were not recognised in the statement of financial position because they did not meet the recognition requirements.

So net asset value is only an approximation to true liquidation values, but it is still widely regarded as a solid underpinning to the share price.

2.8 Other indicators

Ratios are a key tool of analysis but other sources of information and comparisons are also available.

2.8.1 Absolute comparisons

Absolute comparisons can provide information without computing ratios, for example comparing statement of financial position or statement of profit or loss and other comprehensive income amounts between this year and last and identifying changes.

Such comparisons may help to explain changes in ratios; if, for example, the statement of financial position shows that new shares have been issued to repay borrowings or finance new investment, this may explain a change in gearing and ROCE.

2.8.2 Background information

Background information supplied about the nature of the business may help to explain changes or trends, for example you may be told that the business has made an acquisition, disposal or entered a new market. The type of business itself has a major impact on the information presented in the financial statements.

2.8.3 Cash flow information

The statement of cash flows provides information as to how a business has generated and used cash so that users can obtain a fuller picture of liquidity and changes in financial position. Interpretation of cash flow information is covered in the next section.

Interactive question 9: Calculations

Now try this comprehensive example to practise the calculation of various ratios that could be required in the examination.

Ltd Group

Summarised consolidated statement of financial position at 31 December 20X1

	£	£
Non-current assets		2,600
	£	£
Current assets		
Inventories	600	
Trade receivables	900	
Investments	40	
Cash and cash equivalents	60	
		1,600
		4,200

Equity		
Ordinary share capital (£1)		1,000
Retained earnings		650
Attributable to owners of Ltd		1,650
Non-controlling interest		150
Equity		1,800
Non-current liabilities Borrowings	1,400	
Redeemable preference shares	200	
		1,600
Current liabilities		
Trade payables	750	
Bank overdraft	50	
		800
		4,200

Summarised consolidated statement of profit or loss and other comprehensive income for the year ended 31 December 20X1

	£	£
Revenue		6,000
Cost of sales		(4,000)
Gross profit		2,000
Operating expenses		(1,660)
Profit from operations		340
Interest on borrowings	(74)	
Preference share dividend	(10)	
		(84)
Income from investments		5
Profit before tax		261
Tax		(106)
Profit after tax		155
	£	£
Attributable to:		
Owners of Ltd	140	
Non-controlling interest		15
		155

Requirement

Calculate the ratios applicable to Ltd.

Calculations

(1) **Return on capital employed (ROCE)**		
	=	
(2) **Return on shareholders' funds (ROSF)**		
	=	
(3) **Gross profit %**		
	=	
(4) **Net profit margin**		
	=	
(5) **Net asset turnover**		
	=	
(6) **Proof of ROCE**		
ROCE	= Net profit margin	× Net asset turnover
	=	×
(7) **Non-current asset turnover**		
	=	
(8) **Current ratio**		
	=	
(9) **Quick ratio**		
	=	
(10) **Inventory turnover**		
	=	
(11) **Inventory days**		
	=	
(12) **Trade receivables collection period**		
	=	
(13) **Trade payables payment period**		
	=	
(14) **Gearing**		
	=	
(15) **Interest cover**		
	=	

See **Answer** at the end of this chapter.

Note: In an exam it is unlikely you will only be calculating ratios and more likely that you will be putting through adjustments which then alter a significant ratio; for example, gearing when applying for a bank loan. Excel file can be useful here – you need only set the calculation up once and can then copy the formula (relatively) for a comparative year or company. You can also set up the ratio formulae to copy from your adjusted figures.

3 Statements of cash flows and their interpretation

Section overview

- The analysis of the statement of cash flows is essential to an understanding of business performance and liquidity of individual companies and groups.
- Cash flow ratios provide crucial information as a part of financial statement analysis.

The ratios examined so far relate to information presented in the statement of financial position and statement of profit or loss and other comprehensive income. The statement of cash flows provides valuable additional information, which facilitates more in-depth analysis of the financial statements.

The importance of the statement of cash flows lies in the fact that businesses fail through lack of cash, not lack of profits:

(a) A profitable but expanding business is likely to find that its inventories and trade receivables rise more quickly than its trade payables (which provide interest-free finance). Without adequate financing for its working capital, such a business may find itself unable to pay its debts as they fall due.

(b) An unprofitable but contracting business may still generate cash. If, for example, a statement of profit or loss and other comprehensive income is weighed down with depreciation charges on non-current assets but the business is not investing in any new non-current assets, capital expenditure will be less than book depreciation.

IAS 7, *Statement of Cash Flows* therefore requires the provision of information about changes in the cash and cash equivalents of an entity, as a basis for the assessment of the entity's ability to generate cash inflows in the future and its needs to use such cash flows. Cash flow information, when taken with the rest of the financial statements, helps the assessment of:

- changes in net assets
- financial structure
- ability to affect timing and amount of cash flows

Cash flow information also facilitates comparisons between entities, because it is unaffected by different accounting policies – to this extent it is often regarded as more objective than accrual-based information.

3.1 Types of cash flow

3.1.1 Operating activities

Operating cash flows may be compared with profit from operations. The extent to which profits are matched by strong cash flows is an indication of the quality of profit from operations in that, while profit from operations represents the earnings surplus available for dividend distribution, operating cash flows represents the cash surplus generated from trading, which the company can then use for other purposes.

However, caution is required where there are significant non-current assets, because depreciation is included in operating profit, but not operating cash flow. Depreciation could therefore be excluded from operating profit for comparison with cash flows, as the cash flows for non-current asset replacement are presented under investing, not operating, activities.

If operating cash flows are significantly lower than profit from operations, this may indicate that the company is in danger of running out of cash and encountering liquidity problems. In such cases, particular attention needs to be paid to the liquidity and efficiency ratios.

Significant operating cash outflows are unsustainable in the long run. If operating cash flow is negative, this needs to be investigated. Possible reasons include the following:

(a) Building up inventory levels due to expansion of the business, which tends to increase cash paid to suppliers but does not produce profit from operations because costs are included in inventories

(b) Declining revenue or reduced margins

Rapid expansion of a business is often associated with operating cash outflows. In the short term, this need not be a problem provided that sufficient finance is available.

Payments to service debt finance are non-discretionary, in that the terms of loan agreements usually require finance to be serviced, even if the business is not profitable.

If operating cash flows are insufficient to cover the interest cash flows, the company is likely to be in serious financial trouble, unless there is an identifiable non-recurring cause for the shortfall or new equity finance is forthcoming, for example to reduce interest-bearing debts.

Taxation cash flows are also non-discretionary. They tend to lag behind tax charges recognised in the statement of profit or loss and other comprehensive income. In growing businesses, tax cash outflows will often be smaller than tax charges.

Note: Cash payments to manufacture or acquire, and cash receipts on the sale of, assets held for rental to others are cash flows from operating (not investing) activities.

3.1.2 Investing activities

This heading in the statement of cash flows includes cash flows relating to property, plant and equipment. In the short term, these cash flows are discretionary, in that the business will normally survive even if property, plant and equipment expenditure is delayed for some months, or even years.

Significant cash outflows indicate property, plant and equipment additions, which should lead to the maintenance or enhancement of operating cash flows in the long term. However, such investment must be financed, either from operating cash flows or from new financing.

Net outflows on property, plant and equipment replacement can also be compared with the depreciation expense in the statement of profit or loss and other comprehensive income. A significant shortfall of capital spend compared to depreciation may indicate that the company is not replacing its property, plant and equipment as they wear out, or might suggest that depreciation rates are wrongly estimated.

3.1.3 Financing activities

Financing cash flows show how the company is raising finance (by debt or shares) and what finance it is repaying.

The reasons underlying financing cash flows need to be analysed. For example, inflows may be to finance additions to property, plant and equipment to expand the business or renew assets. New share finance may be used to repay debt, thus reducing future interest costs. Alternatively, new financing may be necessary to keep the company afloat if it is suffering significant operating and interest cash outflows. This last situation is unsustainable in the long term, as the company will eventually become insolvent.

3.1.4 Equity dividends paid

Equity dividends paid are, in theory, a discretionary cash flow. However, companies are often under significant investor pressure to maintain dividends even where their profits and cash flows are falling. Equity dividends paid should be compared to the cash flows available to pay them. If a company is paying out a significant amount of the available cash as dividends, it may not be retaining sufficient funds to finance future investment or the repayment of debt.
It is common policy among private equity companies, which own a number of well-known

companies, both in the UK and overseas, to not pay dividends and focus instead on debt minimisation.

3.2 Cash flow ratios

Traditional ratios are based on information in the statement of profit or loss and other comprehensive income and statement of financial position. Some of these can be adapted to produce equivalent ratios based on cash flow.

3.2.1 Cash return on capital employed

(Cash return (see below) ÷ Capital employed) × 100 (Source: SCF ÷ Source: SFP)

Cash return is computed as:

Cash generated from operations	X
Interest received (from investing activities)	X
Dividends received (from investing activities)	X
	X

Capital employed is the same as that used in ROCE.

The cash return is an approximate cash flow equivalent to profit before interest payable. As capital expenditure is excluded from the cash return, care is needed in comparing cash ROCE to traditional ROCE which takes account of depreciation of non-current assets.

3.2.2 Cash from operations/profit from operations

(Cash generated from operations ÷ Profit from operations) × 100 (Source: SCF ÷ Source: SPLOCI)

This measures the quality of the profit from operations. Many profitable companies have to allocate a large proportion of the cash they generate from operations to finance the investment in additional working capital. To that extent, the profit from operations can be regarded as of poor quality, since it is not realised in a form which can be used either to finance the acquisition of non-current assets or to pay back borrowings and/or pay dividends.

So the higher the resulting percentage, the higher the quality of the profits from operations.

3.2.3 Cash interest cover

(Cash return (as above) ÷ Interest paid) × 100 (Source: SCF ÷ Source: SPLOCI)
This is the equivalent of interest cover calculated based on the statement of profit or loss and other comprehensive income. Capital expenditure is normally excluded on the basis that management has some discretion over its timing and amount. Caution is therefore needed in comparing cash interest cover with traditional interest cover, as profit from operations is reduced by depreciation. Cash interest cover will therefore tend to be slightly higher.

3.2.4 Investors' ratios

Cash flow per share

(Cash flow for ordinary shareholders (= cash return as above) – Interest paid – Tax paid) ÷ Number of ordinary shares

(Source: SCF ÷ Source: SFP)

This is the cash flow equivalent of earnings per share. It is common practice to exclude capital expenditure from this measure, because of the discretion over the timing of such expenditure. Therefore caution needs to be exercised in comparing cash flow per share with traditional EPS, as earnings do take account of depreciation.

Cash dividend cover

Cash flow for ordinary shareholders (as above) ÷ Equity dividends paid

This is the cash flow equivalent of dividend cover based on earnings. Similar comments apply regarding exclusion of capital expenditure as are noted under cash flow per share.

Interactive question 10: Calculation of cash flow ratios

The following is a statement of cash flows for a company.

	Year ended 31 March 20X6	
	£'000	**£'000**
Cash flows from operating activities		
Cash generated from operations (Note)		12,970
Interest paid		(360)
Tax paid		(4,510)
Net cash from operating activities Cash flows from investing activities		8,100
Purchase of property, plant and equipment	(80)	
Dividends received	20	
Proceeds on sale of property, plant and equipment	810	
Net cash from investing activities Cash flows from financing activities		750
Dividends paid	(4,500)	
Borrowings	(1,000)	
Net cash used in financing activities		(5,500)
Change in cash and cash equivalents		3,350
Cash and cash equivalents brought forward		2,300
Cash and cash equivalents carried forward		5,650

Note

Reconciliation of profit before tax to cash generated from operations

	£'000
Profit before tax	8,410
Finance cost	340
Amortisation	560
Depreciation	2,640
Loss on disposal of property, plant and equipment	160
Decrease in inventories	570
Decrease in receivables	340
(Decrease) in trade payables	(50)
Cash generated from operations	12,970

The profit from operations for 20X6 is £8,750,000 and the capital employed at 31 March 20X6 was £28,900,000. There were 15 million ordinary shares in issue throughout the year.

Requirement

Calculate the cash flow ratios listed below for 20X6.

Calculation of cash flow ratios

(1) **Cash return**	
Cash generated from operations Interest received Dividends received	= = =
(2) **Cash return on capital employed**	
(Cash return (from above) ÷ Capital employed) × 100	=
(3) **Cash from operations/profit from operations**	
(Cash generated from operations ÷ Profit from operations) × 100	=
(4) **Cash interest cover**	
Cash return ÷ Interest paid	=
(5) **Cash flow per share**	
Cash flow for ordinary shareholders ÷ Number of ordinary shares	=
(6) **Cash dividend cover**	
Cash flow for ordinary shareholders ÷ Equity dividends paid	=

See **Answer** at the end of this chapter.

4 Economic events

Section overview

Economic factors can have a pervasive effect on company performance and should be considered when analysing financial statements.

The economic environment that an entity operates in will have a direct effect on its financial performance and financial position. The economic environment can influence management's strategy but in any event will influence the business performance.

Examples of economic factors that should be considered when analysing financial statements could include:

(a) **State of the economy**

If the economy that a company operates in is depressed then it will have an adverse effect on the ratios of a business. When considering economic events it is important to consider the different geographical markets that a company operates in. These may provide different rates of growth, operating margins, future prospects and risks. An obvious current example is the contrast in the economies of Greece and Germany. Other examples could include emerging markets versus those in recession. Some businesses are more closely linked to economic activity than others, especially if they involve discretionary spending, such as holidays, eating out in restaurants and so on.

(b) **Interest rates and foreign exchange rates**

Increases in interest rates may have adverse effects on consumer demand particularly if the company is involved in supplying products that are discretionary purchases or in industries, such as home improvements, that are sensitive to such movements. Highly geared companies are most at risk if interest rates increase or if there is an economic downturn; their debt still needs to be serviced, whereas ungeared companies are less exposed. Changes in foreign exchange rates will have a direct effect on import and export prices with direct effects on competitiveness.

(c) **Government policies**

Fiscal policy can have a direct effect on performance. For example, the use of trade quotas and import taxes can affect the markets in which a company operates. The availability of government export assistance or a change in levels of public spending can affect the outlook for a company.

(d) **Rates of inflation**

Inflation can have an effect on the comparability of financial statements year on year. It can be difficult to isolate changes due to inflationary aspects from genuine changes in performance.

In analysing the effect of these matters on financial statements, the disclosures required by IFRS 8,
Operating Segments are widely regarded as necessary to meet the needs of users.

5 Business issues

Section overview

The nature of the industry in which the company operates and management's actions have a direct relationship with business performance, position and cash flow.

The information in financial statements is shaped to a large extent by the nature of the business and management's actions in running it. These factors influence trends in the business and cause ratios to change over time or differ between companies.

Examples of business factors influencing ratios are set out below.

(a) **Type of business**

This affects the nature of the assets employed and the returns earned. For example, a retailer may have higher asset turnover but lower margins than a manufacturer and a services business may have very little property, plant and equipment (so low capital employed and high ROCE) while a manufacturer may have lots of property, plant and equipment (so high capital employed and low ROCE).

(b) **Quality of management**

Better managed businesses are likely to be more profitable (and have improved working capital management) than businesses where management is weak. Where management is seen as high quality then this can have a favourable effect.

(c) **Market conditions**

If a market sector is depressed, this is likely to affect companies adversely and make most or all of their ratios appear worse. Diverse conglomerates may operate in a number of different business sectors, each of which is affected by different market risks and opportunities.

(d) **Management actions**

These will be reflected in changes in ratios. For example, price discounting to increase market share is likely to reduce margins but increase asset turnover; withdrawing from unprofitable market sectors is likely to reduce revenue but increase profit margins.

(e) **Changes in the business**

If the business diversifies into wholly new areas, this is likely to change the resource structure and thus impact on key ratios. An acquisition near the year end will mean that capital employed will include all the assets acquired but profits from the acquisition will only be included in the statement of profit or loss and other comprehensive income for a small part of the year, thus tending to depress ROCE. But this can be adjusted for, because IFRS 3, *Business Combinations* requires acquirers to disclose by way of note, total revenue and profit as if all business combinations had taken place on the first day of the accounting period.

Context example: Acquisition during year

A group's revenue for the current period was £10 million (previous year £8 million) and its period end trade receivables were £1.6 million (previous year £900,000). During the year a new subsidiary was acquired which carried trade receivables of £300,000 at the acquisition date.

At first sight there appears to be a very disproportionate increase in trade receivables, up by almost 78% ((1,600/900) – 1) when revenue is up by 25%. But if the previous year receivables are increased by the acquired receivables of £300,000, the increase in receivables is 33% ((1,600/1,200) – 1), more comparable with the revenue increase.

Notes

1 The acquisition renders the period-end trade receivables collection period non-comparable with that for the previous period.

2 The consolidated statement of cash flows will present the trade receivables component in the working capital adjustments as the amount **after** the acquired receivables have been added on to the group's opening balance.

3 IFRS 3 requires disclosure in respect of each acquisition of the amounts recognised at the acquisition date for each class of assets and liabilities and the acquiree's revenue and profit or loss recognised in consolidated profit or loss for the year. In addition, there should be disclosure of the consolidated revenue and profit or loss as if the acquisition date for all acquisitions had been the first day of the accounting period. This allows users to understand the impact of the acquired entity on the financial performance and financial position as evidenced in the consolidated financial statements.

Professional skills focus: Structuring problems and solutions

In approaching a question like this, it is best to adjust the financial statements of the entity that has undertaken the acquisition (or disposal) to make the two accounting periods comparable, so that a meaningful analysis can be carried out.

Context example: Impact of type of business

Set out below are example ratios for two quoted companies:

		Heavy manufacturing	Advertising and media
Return on capital employed	PBIT ÷ Capital employed	13.9%	36.6%
Net margin	PBIT ÷ Revenue	13.2%	3.1%
Net asset turnover	Revenue ÷ Capital employed	1.05 times	11.8 times
Current ratio	Current assets ÷ Current liabilities	1.35:1	0.84:1
Quick ratio	(Current assets – Inventories) ÷ Current liabilities	0.96:1	0.78:1
Gearing	Net debt ÷ Equity	38.4%	104.1%
Interest cover	(PBIT + Investment income) ÷ Interest payable	4.1 times	5.9 times
Inventory turnover	Cost of sales ÷ Inventories	4.5 times	58.8 times
Trade receivables collection period	(Trade receivables ÷ Revenue) × 365	63 days	30 days

This illustration shows that very different types of business can have markedly different ratios. A heavy manufacturing company has substantial property, plant and equipment and work in progress and earns a relatively high margin. An advertising and media company generates a very high ROCE, mainly because its asset base, as reflected in the financial statements, is small. Most of the 'assets' of such a business are represented by its staff, the value of whom is not recognised in the statement of financial position.

In analysing the effect of business matters on financial statements, the segment disclosures required by IFRS 8, *Operating Segments* provide important information that allows the user to make informed judgements about the entity's products and services.

One of the complications in analysing financial statements arises from the way IFRS Standards are structured:

- IAS 1, *Presentation of Financial Statements* sets down the requirements for the format of financial statements, containing provisions as to their presentation, structure and content; but
- the recognition, measurement and disclosure of specific transactions and events are all dealt with in other IFRS Standards.

So preparers of financial statements must consider the possible application of several different IFRS Standards when deciding how to present certain business transactions and business events and users must be aware that details about particular transactions or events may appear in several different parts of the financial statements.

Interactive question 11: The effect of business issues on financial reporting

A listed company operating in the electronics manufacturing sector has decided that due to cost pressures it will downsize its in-country operations. A number of manufacturing facilities will close and the activities will be outsourced to South-East Asian countries.

Requirement

Identify six IASs/IFRS Standards that may need to be considered and briefly give examples of why.

IASs/IFRS Standards

(1)	
(2)	
(3)	
(4)	
(5)	
(6)	

See **Answer** at the end of this chapter.

6 Accounting choices

Section overview

- IFRS Standards include scope for choices in accounting treatment.
- Management make estimates on judgemental matters such as inventory obsolescence that can have a significant effect on the view given.

6.1 Accounting policy choices

The scope for making choices in accounting treatment has been narrowed significantly in recent years due to the development of more prescriptive accounting standards.

Nevertheless, significant choices still exist in a number of areas, for example:

(a) **Asset revaluation**

Revaluation of property, plant and equipment is particularly significant because it affects the total amounts recognised as depreciation expense in profit or loss over the life of an asset. Revaluation also has a significant impact on gearing and ROCE. If assets are revalued upwards, this increases equity and total net assets but does not alter debt. Therefore, the gearing ratio will fall. Asset revaluations also increase capital employed without a pound (£) for pound (£) effect on profits, so the ROCE will fall. Because depreciation is based on the revalued amount, it will rise, further depressing ROCE.

(b) **Cost or fair value model for measurement of investment property**

Where the cost model is used, the asset should be depreciated over its useful life. This produces a systematic expense in profit or loss. The use of the fair value model potentially introduces volatility into profit or loss and capital employed. Key ratios such as ROCE will be more difficult to predict if the fair value model is adopted.

(c) **Classification of financial assets**

Financial assets can be classified in up to four different ways. The classification affects their measurement in the statement of financial performance and the presentation of the gains or losses. This will have a direct effect on profit and capital employed.

The disclosure of accounting policies within the financial statements allows users to understand those policies and adjust financial statements to a different basis, if desired.

Interactive question 12: Asset revaluation

On 1 January 20X1, Tiger Ltd bought for £120,000 an item of plant with an estimated useful life of 20 years and no residual value. Tiger Ltd depreciates its property, plant and equipment on a straight-line basis. Tiger Ltd's year end is 31 December.

On 31 December 20X3, the asset was carried in the statement of financial position as follows:

	£'000
Non-current asset at cost	120
Accumulated depreciation (3 × (120,000 ÷ 20))	(18)
	102

Situation A

The asset continues to be depreciated as previously at £6,000 per annum, down to a carrying amount at 31 December 20X6 of £84,000.

On 1 January 20X7, the asset is sold for £127,000, resulting in a profit of £43,000.

Situation B

On 1 January 20X4, the asset is revalued to £136,000, resulting in a gain of £34,000. The total useful life remains unchanged. Depreciation will therefore be £8,000 per annum; that is, £136,000 divided by the remaining life of 17 years.

On 1 January 20X7, the asset is sold for £127,000, resulting in a reported profit on disposal of £15,000.

Requirement

Ignoring the provisions of IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*, summarise the impact on reported results and net assets of each of the above situations for the years 20X4 to 20X7 inclusive.

See **Answer** at the end of this chapter.

6.2 Judgements and estimates

Even though accounting standards set out detailed requirements in many areas of accounting, management still needs to exercise judgement and make significant estimates in preparing the financial statements.

Examples of judgements and estimates required of management include:

Financial statement area	Judgement or estimation required
Property, plant and equipment	• Depreciation methods • Residual values • Useful lives • Revaluations/impairments
Intangible assets	• Allocation of consideration in a business combination • Future cash flows for impairment tests
	• Amortisation periods
Inventories	• Inclusion of overheads and the normal level of activity • Inventory valuation methods
Lease transactions	• Whether the arrangement constitutes a lease under IFRS 16
Provisions	• Probability of outflow of economic benefits • Measurement of liabilities
Contracts in which performance obligations are satisfied over time	• Estimates of future costs • Estimation of stage of completion • Whether performance obligation(s) are satisfied
Trade receivables	• Collectability and impairment
Segment analysis	• Allocation of common costs to segments • Setting of transfer prices between segments

The increasing use of cash flow analysis by users of financial statements is often attributed to the issues surrounding the inappropriate exercise of judgement in the application of accounting policies.

In certain areas business analysts adjust financial statements to aid comparability to facilitate better comparison. These adjustments are often termed 'coping mechanisms'.

Professional skills focus: Structuring problems and solutions

The use of excel in financial statement analysis can be of considerable value. For example, an excel file can be set up comparing two companies' performance to the previous year and to each other, with formulae calculating percentage increases/decreases, and any significant ratios. This excel file can also be used to consider potential effects of projected changes, for example in revenue or costs. It may be fiddly to set up in the first place, but will save a lot of time in the long run.

7 Ethical issues

Section overview

Ethical issues can arise in the preparation of financial statements. Management may be motivated to improve the presentation of financial information.

The preparation of financial statements requires a great deal of judgement, honesty and integrity. Therefore, Chartered Accountants should employ a degree of professional scepticism when reviewing financial statements and any analysis provided by management.

The financial statements and the associated ratio analysis could be affected by pressure on the preparers of those financial statements to improve the financial performance, financial position or both. Managers of organisations may try to improve the appearance of the financial information to:

- increase their level of bonus pay or other reward benefits;
- deliver specific targets such as EPS growth to meet investors' expectations;
- reduce the risk of corporate insolvency, such as by avoiding a breach of loan covenants;
- avoid regulatory interference, for example where high profit margins are obtained;
- improve the appearance of all or part of the business before an initial public offering or disposal, so that an enhanced valuation is obtained; and
- understate revenues and overstate expenses to reduce tax liabilities.

Users of financial statements must be wary of the use of devices which improve short-term financial position and financial performance. Such inappropriate practices can be broadly summarised into three areas:

(a) **Window dressing of the year-end financial position**

Examples may include the following:

(1) Agreeing with customers that receivables are paid on shorter terms around year end, so that the trade receivables collection period is reduced and operating cash flows are enhanced

(2) Modifying the supplier payment cycle by delaying payments normally made in the last month of the current year until the first month of the following year; this will improve the cash position

(3) Offering incentives to distributors to buy just before year end rather than just after

(b) **Exercise of judgement in applying accounting standards**

Examples may include the following:

(1) Unreasonable cash flow estimates used in justifying the carrying amount of assets subject to impairment tests

(2) Reducing the percentage of outstanding receivables for which full provision is made

(3) Reducing the obsolescence provisions in respect of slow-moving inventories

(4) Extending useful lives of property, plant and equipment to reduce the depreciation charge

(c) **Inappropriate transaction recording**

Examples may include the following:

(1) Additional revenue can be pushed through in the last weeks of the accounting period, only for returns to be accepted and credit notes issued in the next accounting period

(2) Intentionally failing to correct a number of accounting errors which individually are immaterial but are material when taken together

(3) Deferring revenue expenses, such as repairs and maintenance, into future periods

Actions such as these will not make any difference to financial performance over time, because all they do is to shift profit to an earlier period at the expense of the immediately following period.
Financial position can be improved by measures such as these only in the short term. But there may well be short-term benefits to management if these improvements keep the business within its banking covenants or if performance bonuses are to be paid to management if certain profit levels are achieved.

Interactive question 13: Changing payment dates

A company prepares a budget for the months of December 20X5 and January 20X6 and the position at 31 December 20X5 which includes the following:

	£'000
Supplier payments in each of December 20X5 and January 20X6	300
Current assets at 31 December 20X5	
Trade receivables	700
Cash	400
	1,100
Inventories	500
	1,600
Current liabilities at 31 December 20X5	1,000

Requirement

Calculate the current and quick ratios under the following options:

Option 1: Per the budget

Option 2: Per the budget, except that the supplier payments budgeted for December 20X5 are made in January 20X6

Option 3: Per the budget, except that the supplier payments budgeted for January 20X6 are made in December 20X5

Changing payment dates

		Current ratio	Quick ratio
Option 1			
Option 2			
Option 3			

See **Answer** at the end of this chapter.

Finance managers who are part of the team preparing the financial statements for publication must be careful to withstand any pressures from their non-finance colleagues to indulge in reporting practices which dress up short-term performance and position. Financial managers must be conscious of their obligations under the ethical guidelines of the professional bodies of which they are members and in extreme cases may find it useful to seek confidential guidance from ICAB. For members of ICAB, guidance can be found in the Code of Ethics.

Interactive question 14: Ethical pressures

You are the financial controller of Haddock plc. A new Managing Director (MD) with a strong domineering character has recently been appointed by Haddock plc. She has decided to launch an aggressive acquisition strategy and a target company has been identified. You have drafted a report for Haddock plc's management team that identifies several material fair value adjustments which would increase the carrying amount of the acquired assets if the acquisition occurs. The MD has demanded that you revise your report on the fair value adjustments so that the carrying amounts of the acquired assets are materially reduced rather than increased.

Requirement

Identify the motivations of the MD and discuss the actions that you should consider.

Ethical pressures Motivations

(1)	
(2)	
(3)	
(4)	

Actions to consider

(1)	
(2)	
(3)	
(4)	

See **Answer** at the end of this chapter.

8 Industry analysis

Section overview

Industry-specific performance measures can be extremely useful when analysing financial statements.

8.1 Introduction

Some industries are assessed using specific performance measures that take into consideration their specific natures. This is often the case with industries that are relatively young and growing rapidly, for which the traditional finance-based performance criteria do not show the full operational performance.

Many professional analysts use non-financial performance measures when valuing companies for merger and acquisition (M&A) purposes. The M&A industry uses sophisticated tools that combine a variety of figures, both financial and non-financial in nature, when advising clients on the appropriate price to pay for a company.

8.2 Specific industries

Mobile phone operators often quote their growth in subscriber numbers and the average spend per customer per year. This is because such companies have high fixed costs, such as the cost of the communications licence and the maintenance of the mobile mast network; this high operational gearing magnifies the profit effect of increases in customers.

Satellite television companies similarly are keen to quote increases in their customer base.

Context example: BSkyB

BSkyB added more than 70,000 TV customers in the three months to the end of March 2014 – its highest rate in five years. BSkyB said that a focus on marketing its TV products, which include cheaper internet service Now TV, had paid off, with 74,000 new subscribers in the period taking the total TV base to 10.6 million.

BSkyB often quotes the 'churn' rate, which is the percentage of customers who cancel their subscriptions. It is closely monitored by industry analysts, to see whether the growth in subscribers is being offset by existing customers leaving.

Service companies with a finite number of places to offer, such as airlines and hotels, will quote their seat/bed occupancy rates. This is viewed by industry analysts as a measure of the individual success of the company and is compared to both industry averages and competitors.

Retailers are often assessed on sales per square metre of floor space. Such information can be used by external users to compare the performance of retailers operating within the same industry, and also internally by management to identify poorly performing stores operated by the organisation.

Retailers will also quote 'like for like' sales. This is the growth in sales revenues, after stripping out the impact of new stores that have opened during the year. The reason for this is that they can demonstrate to users that they are increasing revenues both organically from existing outlets as well as by expanding their operations. Analysts may also look at like for like sales to arrive at a less optimistic picture, as in the example below.

(Source: Sweney, M. (1 May 2014) BSkyB's TV customers rise by 74,000, but broadband growth slows. *The Guardian*. [Online]. Available from: www.theguardian.com/media/2014/may/01/bskyb-tv- broadband-now-tv [Accessed 7 October 2022])

Context example: J Sainsbury plc

From The Motley Fool website:

March 2014 saw Sainsbury's underlying sales rise by 2.8%, although like for like sales only gained 0.2%.

(Source: Oscroft, A. (22 September 2014) The best reason to buy J Sainsbury plc. *The Motley Fool*. [Online]. Available from: www.fool.co.uk/investing/2014/09/22/the-best-reason-to-buy-j-sainsbury- plc/ [Accessed 7 October 2022])

Context example: Professional service companies

Some of the specific performance measures used in professional service companies include the following:

- Fees per partner (or director)
- Chargeability percentage of staff – this could be calculated as the total hours billed to clients divided by the total number of available hours
- Employee turnover – this could be calculated as the number of voluntary resignations and terminations, divided by the total number of employees at the beginning of the period
- Average fee recovery per hour – this could be calculated as the total fee income divided by the number of hours incurred
- Days of unbilled inventory

9 Non-financial performance measures

Section overview

Non-financial performance measures can often be as important as financial performance measures in analysing financial statements.

9.1 Profit-seeking entities

Company performance can be measured in terms of volume growth as well as financial growth. Some companies will therefore present non-financial information in the form of growth in the level of sales in terms of units. An oil company might quote barrels of oil produced, a games console company the units sold at launch. This is especially important if the price for the product is erratic, such as oil or raw materials.

Market share is also an important benchmark of success within an industry. This can be used as a benchmark of the success of an individual product line, or used as the basis to increase other types of revenues.

Context example: Market shares

A web traffic analysis firm reported that in April 2012 Microsoft had a 50% share of the web browser market (April 2011: 55%). In the same month Mozilla Firefox had a 19% share (down in the year from 22%), followed by Google's Chrome at 17% (up from 12%) and Apple's Safari at 9% (up from 7%).

(Source: Yung-Hui, L. (6 April 2012) Internet Explorer Fightback: Q&A with IE Lead of Microsoft Asia Jonathan Wong. *Forbes*. [Online]. Available from: www.forbes.com/sites/limyunghui/2012/04/06/internet-explorer-fightback-qa-with-ie-lead-of-microsoft-asia-jonathan-wong/#71a778187263 [Accessed 7 October 2022])

Other interested parties can also make use of the financial statements. For example, there may be information relating to the number of employees working at an entity. Such information can be used to assess employment prospects, as a company that is increasing its number of staff probably has greater appeal to prospective employees. Staff efficiency can also be calculated by calculating the average revenue per employee.

However, as with all performance measures, care must be taken to make sure the information means what it says. For example, a company might outsource a significant number of its functions, such as HR, IT, payroll after-sales service and so on. Thus it would appear to have a relatively low employee base compared to a competitor who operated such functions in-house. Comparability would be distorted.

9.2 Not for profit entities

Not all entities are profit-seeking. Schools, hospitals, charities and so on may all have objectives that are not financially based. However, they may be assessed by interested parties and present information alongside their financial statements.

Institution	Performance measure
Hospital	Speed at attending to patients, success rates for certain types of operation, length of waiting lists
School	Exam pass rates, attendance records of pupils, average class sizes
Charity	Percentage of income spent on administrative expenses, speed of distribution of income

10 Limitations of ratios and financial statement analysis

Section overview

Below is a summary of the limitations of ratios and financial statement analysis.

Financial statement analysis is based on the information in financial statements so ratio analysis is subject to the same limitations as the financial statements themselves.

(a) Ratios are not definitive measures. They provide clues to the financial statement analysis but qualitative information is invariably required to prepare an informed analysis.

(b) Ratios calculated on the basis of published, and therefore incomplete, data are of limited use. This limitation is particularly acute for those ratios which link statement of financial position and income statement figures. A period-end statement of financial position may well not be at all representative of the average financial position of the business throughout the period covered by the income statement.

(c) Ratios use historical data, which may not be predictive, as it ignores future actions by management and changes in the business environment.

(d) Ratios may be distorted by differences in accounting policies between entities and over time.

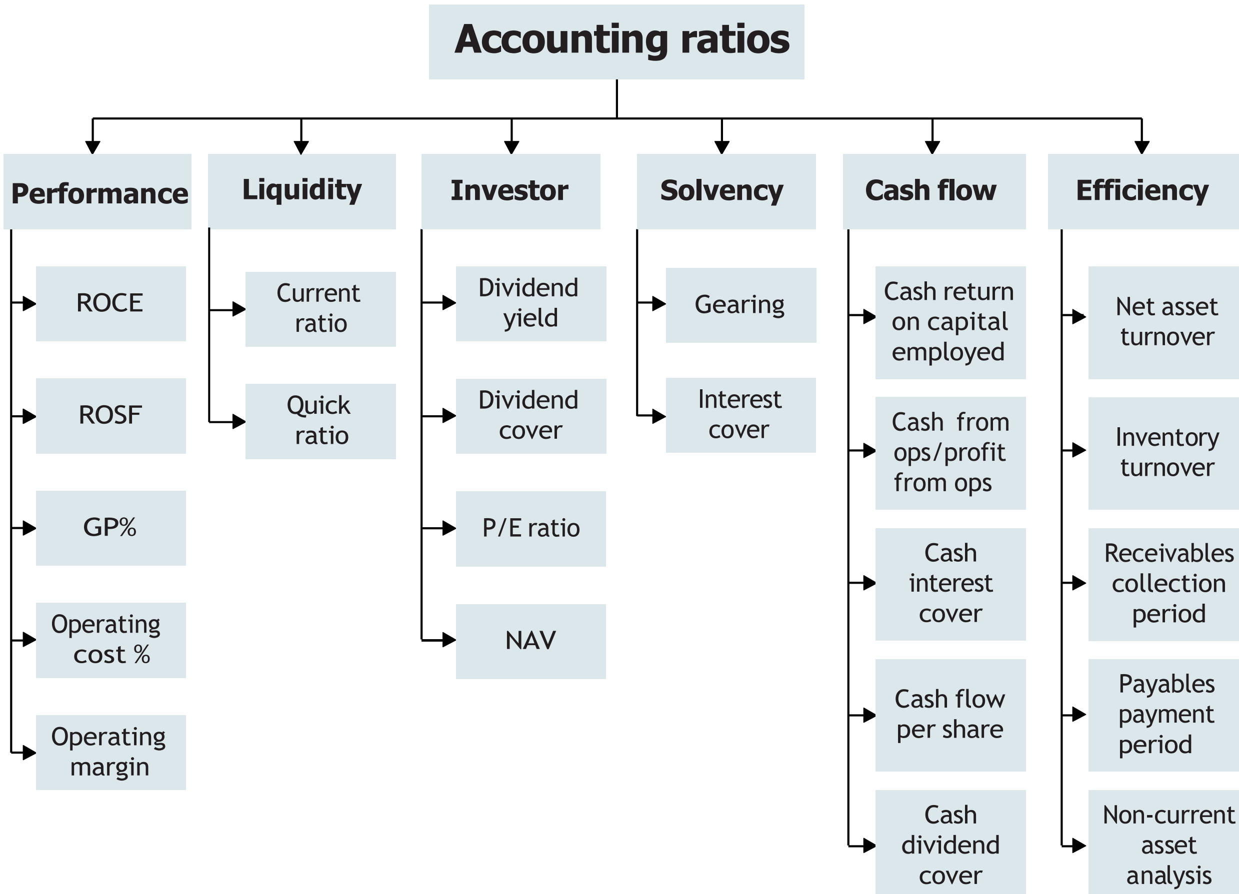
(e) Ratios are based on figures from the financial statements. If there is financial information that is not captured within the financial statements (such as changes to the company reputation), then this will be ignored.

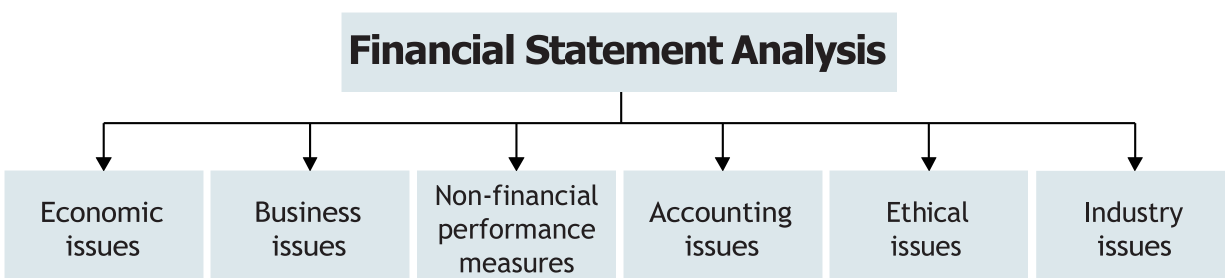
(f) Comparisons between different types of business are difficult because of differing resource structures and market characteristics. However, it may be possible to make indirect comparisons between businesses in different sectors, by comparing each to its own sector averages.

(g) Window dressing and creative practices can have an adverse effect on the conclusions drawn from the interpretation of financial information.

(h) Price changes can have a significant effect on time-based analysis across a number of years.

Summary


Accounting ratios
Performance
ROCE
ROSF
GP%
Operating cost %
Operating margin
Liquidity
Current ratio
Quick ratio
Investor
Dividend yield
Dividend cover
P/E ratio
NAV
Solvency
Gearing
Interest cover
Cash flow
Cash return on capital employed
Cash from ops/profit from ops
Cash interest cover
Cash flow per share
Cash dividend cover
Efficiency
Net asset turnover
Inventory turnover
Receivables collection period
Payables payment period
Non-current asset analysis


Financial Statement Analysis
Economic issues
Business issues
Non-financial performance measures
Accounting issues
Ethical issues
Industry issues

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	How would an investor or potential investor use financial analysis? (Topic 1)
2.	How is ROCE calculated and used? (Topic 2)
3.	What are the drawbacks of the current ratio? (Topic 2)
4.	What are the drawbacks of the gearing ratio? (Topic 2)
5.	Can you analyse a statement of cash flows? (Topic 3)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Wild Swan	Individual ratio calculation practice was provided within the chapter, so the first self-test question has a full set of financial statements for you to interpret. Comments are as important as calculations.
Brass	Another comprehensive question, this time with notes to the financial statements and prior year ratios calculated
Trendsetters	This question requires calculations of cash flow ratios and interpretation of a statement of cash flows.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted the self-test questions, you can continue your studies by moving onto the next chapter. In later chapters, we will recommend questions from the Question Bank for you to attempt.

Self-test questions

Answer the following questions

1 **Wild Swan**

The following extracts have been taken from the financial statements of Wild Swan Ltd, a manufacturing company.

Statements of financial position as at 31 December

		20X3		**20X2**
	£'000	**£'000**	**£'000**	**£'000**
Assets				
Non-current assets				
Property, plant and equipment		4,465		2,819
Current assets				
Inventories	1,172		1,002	
Trade and other receivables	2,261		1,657	
Cash and cash equivalents	386		3	
		3,819		2,662
Total assets		8,284		5,481
Equity and liabilities				
Ordinary share capital		522		354
Preference share capital (irredeemable – 8%)		150		150
Revaluation surplus		1,857		–
Retained earnings		2,084		2,094
Equity		4,613		2,598
Non-current liabilities				
Borrowings		105		–
Current liabilities				
Trade and other payables	1,941		1,638	
Taxation	183		62	
Bank overdraft	1,442		1,183	
		3,566		2,883
Total equity and liabilities		8,284		5,481

Statements of profit or loss and other comprehensive income for year ended 31 December

	20X3 £'000	20X2 £'000
Revenue	24,267	21,958
Cost of sales	(20,935)	(19,262)
Gross profit	3,332	2,696
Net operating expenses	(2,604)	(2,027)
Profit from operations	728	669
Net finance cost payable	(67)	(56)
Profit before tax	661	613
Taxation	(203)	(163)
Profit for the year	458	450
Other comprehensive income for the year		
Revaluation of property, plant and equipment	1,857	
Total comprehensive income for the year	2,315	450

Statements of changes in equity for the year ended 31 December (total columns)

	20X3 £'000	20X2 £'000
Balance brought forward	2,598	2,400
Total comprehensive income for the year	2,315	450
Issue of ordinary shares	168	-
Final dividends on ordinary shares	(300)	(180)
Interim dividends on ordinary shares	(156)	(60)
Dividends on irredeemable preference shares	(12)	(12)
Balance carried forward	4,613	2,598

Statement of cash flows for the year ended 31 December 20X3

	£'000	£'000
Cash flows from operating activities		
Cash generated from operations		1,208
Interest paid		(67)
Tax paid		(82)
Net cash from operating activities		1,059
Cash flows from investing activities Purchases of non-current assets	(1,410)	
Proceeds on sale of property, plant and equipment	670	
Net cash used in investing activities Cash flows from financing activities		(740)
Dividends paid	(468)	

	£'000	£'000
Proceeds from borrowings	105	
Issue of shares	168	
Net cash used in financing activities		(195)
Net change in cash and cash equivalents		124
Cash and cash equivalents brought forward (3 – 1,183)		(1,180)
Cash and cash equivalents carried forward (386 – 1,442)		(1,056)

Reconciliation of profit before tax to cash generated from operations

	£'000
Profit before tax	661
Depreciation charge	965
Profit on disposal of property, plant and equipment	(14)
Finance cost	67
Increase in inventories	(170)
Increase in trade and other receivables	(604)
Increase in trade and other payables	303
Cash generated from operations	1,208

Key ratios

	20X3	20X2
Gross profit percentage	13.7%	12.3%
Net margin	3.0%	3.0%
Net asset turnover	4.2 times	5.8 times
Trade receivables collection period	34 days	28 days
Interest cover	10.9	11.9
Current ratio	1.1	0.9
Quick ratio	0.7	0.6

Cash flow ratios (20X3 only)

Cash return on capital	22.1%
Cash interest cover	18 times

Requirements

1.1 Calculate return on capital employed and gearing (net debt/equity) for both years.

1.2 Comment on the financial performance and position and on the statement of cash flows of Wild Swan Ltd in the light of the above information.

2 Reapson

Statement of changes in equity extract for the year ended 31 December 20X4

Attributable to the owners of Reapson plc	**Revaluation surplus £m**	**Retained earnings £m**
Balance brought forward	–	800.00
Total comprehensive income for the year	350.00	222.90
Transfer between reserves	(17.50)	17.50
Dividends on ordinary shares		(81.75)
Balance carried forward	332.50	958.65

As well as revaluing property, plant and equipment during the year (incurring significant additional depreciation charges) Reapson plc incurred £40 million of costs relating to the closure of a division.

Reapson plc has £272.5 million of 50p ordinary shares in issue. The market price per share is 586p.

Requirement

(1) Dividend per share			= 15p
(2) Earnings per share	= Profit before ordinary dividends ÷ No. of ordinary shares in issue	= 222.9 ÷ 545	= 40.9p
(3) Dividend cover	= EPS ÷ Dividend per share	= 40.9 ÷ 15	= 2.7
(4) Dividend yield	= Dividend per share ÷ Current market price per share	= 15 ÷ 586	= 2.6%
(5) Price/earnings ratio	= Current market price per share ÷ EPS	= 586 ÷ 40.9	= 14.3

Explain the above statistics from a financial journal referring to Reapson plc and relate them to the above information.

3 Verona

Verona plc is a parent company. The Verona plc group includes two manufacturers of kitchen appliances. One of these companies, Nice Ltd, serves the North of England and Scotland. The other company, Sienna Ltd, serves the Midlands, Wales and Southern England. Each of the two companies manufactures an identical range of products.

Verona plc has a quarterly reporting system. Each group member is required to submit an abbreviated set of financial statements to head office. This must be accompanied by a set of ratios specified by the board of Verona plc. All manufacturing companies, including Nice Ltd and Sienna Ltd, are required to calculate the following ratios for each quarter:

- Return on capital employed
- Trade receivables collection period
- Trade payables payment period
- Inventory turnover (based on average inventories)

The financial statements for the three months (that is, 89 days) ended 30 April 20X3, submitted to the parent company, were as shown below.

Statements of profit or loss and other comprehensive income for the quarter ended

		Nice Ltd		Sienna Ltd
	£'000	£'000	£'000	£'000
Revenue		3,000		4,400
		Nice Ltd		**Sienna Ltd**
	£'000	£'000	£'000	£'000
Opening inventories	455		684	
Purchases	1,500		2,100	
	1,955		2,784	
Closing inventories	(539)		(849)	
Cost of materials	1,416		1,935	
Wages and salaries	700		960	
Depreciation	128		83	
Cost of sales		(2,244)		(2,978)
Gross profit		756		1,422
Marketing	450		570	
Administration	147		238	
Loan interest	10		–	
Overdraft interest			5	
		(607)		(813)
Profit for the period		149		609

Statements of financial position at 30 April 20X3

		Nice Ltd		Sienna Ltd
	£'000	£'000	£'000	£'000
Assets				
Non-current assets				
Property		2,000		1,300
Plant and equipment		1,700		1,100
Current assets		3,700		2,400
Inventories	539		849	
Trade and other receivables	1,422		1,731	
Cash and cash equivalents	71			
		2,032		2,580
Total assets		5,732		4,980
Equity and liabilities				
Equity				
Ordinary share capital		1,745		479
Revaluation surplus		700		–
Retained earnings		2,049		3,309
Equity		4,494		3,788

	£'000	Nice Ltd £'000	£'000	Sienna Ltd £'000
Non-current liabilities				
Borrowings		800		
		5,294		3,788
Current liabilities				
Trade and other payables	438		1,062	
Overdraft			130	
		438		1,192
Total equity and liabilities		5,732		4,980

The managing director of Nice Ltd feels that it is unfair to compare the two companies on the basis of the figures shown above, even though they have been calculated in accordance with the group's standardised accounting policies. The reasons he puts forward are as follows.

- Verona plc is in the process of revaluing all land and buildings belonging to group members. Nice Ltd's properties were revalued up by £700,000 on 1 February 20X3 and this revaluation was incorporated into the company's financial statements. The valuers have not yet visited Sienna Ltd and that company's property is carried at cost less depreciation.

  The Verona group depreciates property on a quarterly basis, calculated at a rate of 4% per annum.
- Nice Ltd's new production line costing £600,000 became available for use during the final week of the period under review. The cost of purchase was borrowed from a bank and is included in the figures for non-current borrowings.

  The managing director of Nice Ltd believes the effect of the purchase of this machine should be removed, as it happened so close to the period end.

  The Verona group depreciates machinery at a rate of 25% of cost per annum.
- Nice Ltd supplied the Verona group's hotel division with goods to the value of £300,000 in October 20X2. This amount is still outstanding and has been included in Nice Ltd's trade receivables figure. Nice Ltd has been told that this balance will not be paid until the hotel division has sufficient liquid funds.
- Nice Ltd purchased £400,000 of its materials, at normal trade prices, from a fellow member of the Verona group. This supplier had liquidity problems and the group's corporate treasurer ordered Nice Ltd to pay for the goods as soon as they were delivered.

Requirements

3.1 Calculate the ratios required by the Verona group for both Nice Ltd and Sienna Ltd for the quarter, using the figures in the financial statements submitted to the holding company.

3.2 Explain briefly which company's ratio appears the stronger in each case.

3.3 Explain how the information in the notes above has affected Nice Ltd's return on capital employed, trade receivables collection period and trade payables payment period.

3.4 Explain how the calculation of the ratios should be adjusted to provide a fairer basis for comparing Nice Ltd with Sienna Ltd.

4 Brass Ltd

You are the financial accountant of Brass Ltd, a company which operates a brewery and also owns and operates a chain of hotels and public houses. Your managing director has obtained a copy of the latest financial statements of Alliance Breweries Ltd, a competitor, and has gained the impression that, although the two companies are of a similar overall size, Alliance's performance is rather better than that of Brass Ltd.

He is also concerned about his company's ability to repay a £20 million loan. The statements of profit or loss and other comprehensive income and statements of financial position of the two companies for the year to 31 December 20X2 and extracts from the notes are set out below.

Statements of profit or loss and other comprehensive income

		Brass Ltd		**Alliance Breweries Ltd**
	£'000	**£'000**	**£'000**	**£'000**
Revenue		157,930		143,100
Cost of sales		(57,400)		(56,500)
Gross profit		100,530		86,600
Distribution costs	27,565		21,502	
Administrative expenses (Note 2)	53,720		29,975	
		(81,285)		(51,477)
Profit from operations		19,245		35,123
Finance cost		(2,000)		
Profit before tax		17,245		35,123
Tax		(5,690)		(11,590)
Profit for the year		11,555		23,533

Statements of financial position

		Brass Ltd		**Alliance Breweries Ltd**
	£'000	**£'000**	**£'000**	**£'000**
Assets				
Non-current assets				
Property, plant and equipment (Note 3)		71,253		69,570
Intangibles (Note 2)				3,930
		71,253		73,500
Current assets				
Inventories	7,120		4,102	
Trade and other receivables	28,033		22,738	
Cash and cash equivalents	5,102			
		40,255		26,840
Total assets		111,508		100,340
Equity and liabilities				
Equity				
Ordinary share capital		30,000		50,000
Revaluation surplus		15,253		–
Retained earnings		16,775		32,080
		62,028		82,080
Non-current liabilities (10% loan)		20,000		–
Current liabilities (Note 4)		29,480		18,260
Total equity and liabilities		111,508		100,340

Notes

1 Intangible assets – Alliance Breweries Ltd. Intangible assets include brand names and trademarks purchased from Odlingtons Breweries Ltd in 20X0, which are being amortised over their useful lives.

2 Administrative expenses including the following:

	Brass Ltd	Alliance Breweries Ltd
	£'000	£'000
Directors' remuneration	2,753	1,204
Advertising and promotion	10,361	2,662

3 The company's freehold land and buildings were revalued during 20X0 by the directors (see tables below).

4 Current liabilities

	Brass Ltd	Alliance Breweries Ltd
	£'000	£'000
Trade payables	23,919	7,875
Taxation	5,561	10,235
Bank overdraft		150
	29,480	18,260

5 Non-current liabilities: The 10% loan is redeemable in June 20X4.

6 Both companies have similar accounting policies apart from depreciation where the policies are as the tables below.

Land and building revaluation

Brass Ltd – Property, plant and equipment

	Freehold land and buildings £'000	Motor vehicles £'000	Plant and machinery £'000	Total £'000
Cost or valuation 1 January 20X2	113,712	655	3,397	117,764
Additions	3,150	125	523	3,798
Cost or valuation 31 December 20X2	116,862	780	3,920	121,562
Provision for depreciation 1 January 20X2	(43,239)	(272)	(2,548)	(46,059)
Charge for year	(3,506)	(156)	(588)	(4,250)
Provision for depreciation 31 December 20X2	(46,745)	(428)	(3,136)	(50,309)
Carrying amount 31 December 20X2	70,117	352	784	71,253

C H A P T E R 23

Alliance Breweries Ltd – Property, plant and equipment

	Freehold brewery £'000	Freehold hotels and public houses £'000	Motor vehicles £'000	Plant and machinery £'000	Total £'000
Cost 1 January 20X2	5,278	80,251	874	5,612	92,015
Additions		8,920	79	489	9,488
Cost 31 December 20X2	5,278	89,171	953	6,101	101,503
Provision for depreciation					
1 January 20X2	(2,771)	(23,291)	(477)	(3,838)	(30,377)
Charge for year	(96)	(490)	(238)	(732)	(1,556)
Provision for depreciation					
31 December 20X2	(2,867)	(23,781)	(715)	(4,570)	(31,933)
Carrying amount					
31 December 20X2	2,411	65,390	238	1,531	69,570

Accounting policies Brass Ltd – Depreciation

Depreciation is provided by the company to recognise in profit or loss the cost of property, plant and equipment on a straight-line basis over the anticipated life of the assets as follows.

	%
Freehold buildings	4
Motor vehicles	20
Plant and equipment	10-33

Freehold land is not depreciated.

Leasehold property is amortised over the term of the lease.

Alliance Breweries Ltd – Depreciation

Property, plant and equipment are depreciated over their useful lives as follows.

	%
Motor vehicles	25
Plant and equipment	10-25
Freehold land	Nil
Freehold buildings	1

The following ratios have been calculated for Brass Ltd for the year ended 31 December 20X2.

(1) ROCE = Profit before interest and tax ÷ Capital employed = 19,245 ÷ (62,028 + 20,000 – 5,102) = 25%

(2) Asset turnover = Revenue ÷ Capital employed = 157,930 ÷ (62,028 + 20,000 – 5,102) = 2.05

(3) Net profit margin = Profit before interest and tax ÷ Revenue = 19,245 ÷ 157,930 = 12.2%

(4) Gross profit percentage = Gross profit ÷ Revenue = 100,530 ÷ 157,930 = 63.7%

(5) Current ratio = Current assets ÷ Current liabilities = 40,255 ÷ 29,480 = 1.37

(6) Quick ratio = (Current assets – Inventories) ÷ Current liabilities = 33,135 ÷ 29,480 = 1.12

(7) Trade receivables collection period = Trade receivables ÷ Revenue = (28,033 ÷ 157,930) ×

365 = 65 days

(8) Inventory turnover = Cost of sales ÷ Inventory = 57,400 ÷ 7,120 = 8.1

Requirements

4.1 Prepare a report to the managing director comparing the profitability and liquidity of Brass Ltd with Alliance Breweries Ltd, using the ratios given for Brass Ltd and appropriate accounting ratios for Alliance Breweries Ltd and suggest possible reasons for the differences between the results of the two companies.

4.2 State briefly what adjustments would be necessary to the financial statements of the companies for a more relevant comparison of their relative performance.

5 Caithness plc

Caithness plc, a parent company, requires sets of management information, including key ratios, from all its subsidiaries. The most recent sets of information for two of its subsidiaries, Sutherland Ltd and Argyll Ltd, two manufacturing companies, show the following.

		Sutherland
	Ltd	**Argyll Ltd**
Return on capital employed (ROCE)	5%	13%
Gross profit percentage	30%	35%
Net margin	13%	10%
Current ratio	2.5:1	3:1
Quick ratio	1.8:1	2.7:1
Trade receivables collection period	60 days	45 days
Trade payables payment period	40 days	50 days
Inventory turnover	60 days	20 days
Gearing (debt/equity)	55%	100%
Interest cover	4 times	2 times
Cash return on capital employed (cash ROCE)	7%	8%

Additional information:

(1) Each company is treated as a mainly autonomous unit, although they share an accounting function and Caithness plc does determine the dividend policy of the two subsidiaries. Companies in the group must use the same accounting policies.

(2) It is group policy to record all assets at cost less accumulated depreciation and impairment losses. However, Sutherland Ltd has revalued its freehold property and included the results in the recent management information above.

(3) Argyll Ltd has recently leased a specialised item of plant and machinery. In the management information above the lease rentals have been recognised as an expense in profit or loss, but the managing director has been told by the financial controller that this is not permitted under IFRS 16, *Leases,* and the group directors are aware that the year-end published financial statements will need to reflect the correct treatment.

(4) Sutherland Ltd and Argyll Ltd trade with other companies in the group. At the instigation of Argyll Ltd, Sutherland Ltd has supplied one of the other companies in the group with goods with a selling price of £200,000. These are no longer in group inventories but Sutherland Ltd has been told that the goods will not be paid for until the liquidity problems of the other company are resolved.

Requirements

5.1 Comment on the relative financial performance and position of Sutherland Ltd and Argyll Ltd from the above information.

5.2 Identify what further information you would find useful to help with your commentary in (5.1), providing reasons.

5.3 It transpires that the managing director of Argyll Ltd, who was previously head of the accounting function for both companies, was aware, at the time of preparing the above information, that Caithness plc is considering selling its stake in one of these companies and that Caithness plc intends to use the information to help it in making its decision.

Comment on the information above in the light of this and set out any additional information which would help you to form a view on the situation.

6 Trendsetters Ltd

Trendsetters Ltd is a long-established chain of provincial fashion boutiques, offering mid-price clothing to a target customer base of late teens/early twenties. However, over the past eighteen months, the company appears to have lost its knack of spotting which trends from the catwalk shows will succeed on the high street. As a result, the company has had to close a number of its stores just before its year end of 31 December 20X2.

You have been provided with the following information for the years ended 31 December 20X1 and 20X2.

Statement of cash flows for the year ended 31 December

	20X2 £'000	20X1 £'000
Cash flows from operating activities		
Cash generated from operations	869	882
Interest paid	(165)	(102)
Tax paid	(13)	(49)
Net cash from operating activities	691	731
Cash flows from investing activities		
Dividends received	–	55
Proceeds from sales of investments	32	–
Proceeds from sale of property, plant and equipment	1,609	12
Net cash from investing activities	1,641	67
Cash flows from financing activities		
Dividends paid	–	(110)
Borrowings taken out	500	100
Net cash from/(used in) financing activities	500	(10)
Net change in cash and cash equivalents	2,832	788
Cash and cash equivalents brought forward	910	122
Cash and cash equivalents carried forward	3,742	910

Reconciliation of profit before tax to cash generated from operations

	20X2	20X1
	£'000	£'000
Profit before tax	2,293	162
Investment income	–	(55)
Finance cost	165	102
Depreciation charge	262	369
Loss on disposal of investments	101	–
Profit on disposal of property, plant and equipment	(1,502)	(2)
Increase in inventories	(709)	(201)
Increase/decrease in trade and other receivables	(468)	256
Increase in trade and other payables	727	251
Cash generated from operations	869	882

Extracts from the statement of profit or loss and other comprehensive income and statement of financial position for the same period were as follows.

	20X2	20X1
	£'000	£'000
Revenue	2,201	3,102
Equity and liabilities		
Equity		
Ordinary share capital	100	100
Retained earnings	7,052	4,772
Long-term liabilities	7,152	4,872
Borrowings	1,500	1,000
Current liabilities		
Trade and other payables	1,056	329
	9,708	6,201

Requirements

6.1 Comment on the above information, calculating three cash flow ratios to help you in your analysis.

6.2 You have now learnt that the financial controller of Trendsetters Ltd has been put under severe pressure by his operational directors to improve the figures for the current year.

Discuss how this pressure might have influenced both the above information and other areas of the financial statements, and suggest what actions the financial controller should consider in responding to these pressures.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

ROCE and ROSF

(1)	Target return on capital (company or shareholder)
(2)	Real interest rates
(3)	Age of plant
(4)	Leased/owned assets
(5)	Upward revaluations of non-current assets, which increase capital employed, increase depreciation charges and reduce ROCE/ROSF

Answer to Interactive question 2

Gross profit percentage

(1)	Change in sales prices
(2)	Change in sales mix
(3)	Change in purchase/production costs
(4)	Inventory obsolescence

Answer to Interactive question 3

Operating cost percentage

(1)	Change in the amount of sales – investigate whether due to price or volume changes
(2)	Non-recurring costs

Answer to Interactive question 4

Current and quick ratios

Low and high ratios could suggest the following:

- Liquidity problems (low ratio)
- Poor use of shareholder/company funds (high ratio)

Two possible factors to investigate would be as follows:

- Constituent components of ratio: inventory obsolescence (in case of current ratio), recoverability of receivables (in case of both ratios)
- Manipulation – if company has positive cash balances and a ratio greater than 1:1, payment of current liabilities such as trade payables just before the year end will improve ratio

Answer to Interactive question 5

Gearing

(1)	Upward revaluations of non-current assets increase shareholders' funds and decrease gearing.
(2)	Whether carrying amounts of non-current assets are likely to be volatile.

Answer to Interactive question 6

Inventory turnover

(1)	High inventory turnover rate – may be efficient but the risk of running out of inventory is increased
(2)	Low inventory turnover rate – inefficient use of resources and potential obsolescence problems

Remember: the inventory turnover rate can be affected by seasonality. The year-end inventory position may not reflect the average level of inventory.

Answer to Interactive question 7

Trade receivables collection period

(1)	Bad debt/collection problems
(2)	Change in nature of customer base (new customer is big but is a slow payer)
(3)	Change in settlement terms

Remember: the year-end receivables may not be representative of the average over the year.

Answer to Interactive question 8

Trade payables payment period

(1)	High figure may indicate liquidity problems
(2)	Potential appointment of receiver by aggrieved suppliers

Remember: the year-end payables may not be representative of the average over the year.

Answer to Interactive question 9

Calculations

(1) **Return on capital employed (ROCE)**	
(Profit before interest and tax ÷ Capital employed) × 100	= (340 ÷ (1,800 + 1,600 + 50 – 60)) × 100 = 10%
(2) **Return on shareholders' funds (ROSF)**	
Profit attributable to owners of a parent company ÷ (Equity – non-controlling interest)	= (140 ÷ (1,800 – 150)) × 100 = 8.5%

(3) **Gross profit %**		
(GP ÷ Revenue) × 100	= (2,000 ÷ 6,000) × 100 = 33.33%	
(4) **Net profit margin**		
(Profit before interest and tax ÷ Revenue) × 100	= (340 ÷ 6,000) × 100 = 5.7%	
(5) **Net asset turnover**		
Revenue ÷ Capital employed	= (6,000 ÷ (1,800 + 1,600 + 50 – 60)) = 1.8 times	
(6) **Proof of ROCE**		
ROCE	= Net profit margin	× Net asset turnover
10%	= 5.7%	× 1.8 times
(7) **Non-current asset turnover**		
Revenue ÷ Non-current assets	= (6,000 ÷ 2,600) = 2.3 times	
(8) **Current ratio**		
Current assets ÷ Current liabilities	= (1,600 ÷ 800) = 2 times	
(9) **Quick ratio**		
Current assets less inventories ÷ Current liabilities	= ((1,600 – 600) ÷ 800) = 1.25 times	
(10) **Inventory turnover**		
Cost of sales ÷ Inventories	= (4,000 ÷ 600) = 6.66 times	
(11) **Inventory days**		
(Inventories ÷ Cost of sales) × 365	= (600 ÷ 4,000) × 365 = 55 days	
(12) **Trade receivables collection period**		
(Trade receivables ÷ Revenue) × 365	= (900 ÷ 6,000) × 365 = 55 days	
(13) **Trade payables payment period**		
(Trade payables ÷ Cost of sales) × 365	= (750 ÷ 4,000) × 365 = 68 days	
(14) **Gearing**		
(Net debt ÷ Equity) × 100	= ((1,600 + 50 – 60) ÷ 1,800) × 100 = 88.3%	
(15) **Interest cover**		
(PBIT + Investment income) ÷ Interest payable	= (340 + 5) ÷ 84 = 4.1 times	

Answer to Interactive question 10

Calculation of cash flow ratios

(1) **Cash return**	
Cash generated from operations Interest received Dividends received	= 12,970 = – = 20
	12,990
(2) **Cash return on capital employed**	
(Cash return (from above) ÷ Capital employed) × 100	= (12,990 ÷ 28,900) × 100 = 44.9%
(3) **Cash from operations/profit from operations**	
(Cash generated from operations ÷ Profit from operations) × 100	= (12,970 ÷ 8,750) × 100 = 148%
(4) **Cash interest cover**	
Cash return ÷ Interest paid	= 12,990 ÷ 360 = 36 times
(5) **Cash flow per share**	
Cash flow for ordinary shareholders ÷ Number of ordinary shares	= (12,990 – 360 – 4,510) ÷ 15,000 = 54p per share
(6) **Cash dividend cover**	
Cash flow for ordinary shareholders ÷ Equity dividends paid	= (12,990 – 360 – 4,510) ÷ 4,500 = 1.8 times

Answer to Interactive question 11

IASs/IFRS Standards

(1)	IAS 7's requirements as to disclosure within investing activities of the cash flows resulting from disposals
(2)	IAS 10's requirements as to events occurring after the end of the reporting period, whether they are adjusting events (that is, confirmation of the carrying amounts of assets/liabilities) or non-adjusting events (for example, the disclosure of a decision to restructure)
(3)	IFRS 8's requirements as to segment reporting – a disposal could well affect the segments which are reportable
(4)	IFRS 5's requirements – a decision to restructure a major part of the business is likely to lead to disclosures of both discontinued operations in the statement of profit or loss and other comprehensive income and non-current assets held for sale in the statement of financial position
(5)	IAS 36's requirements as to impairment of assets – impairment will almost certainly result from a restructuring decision

(6)	IAS 37's requirements as to provisions – liabilities which previously were only contingent may well now require recognition and provisions for restructuring costs may need to be recognized

The effect of business issues on financial reporting

Decisions to dispose of a group company or to close down a business activity within the group result in restructurings. The decision to restructure a major part of the business will require consideration of the above IASs/IFRS Standards.

Other standards such as IAS 2, *Inventories* may also be relevant. Any surplus or excess inventory may require disposal at below cost. In addition, the presentation of these events may need the consideration of IAS 1, *Presentation of Financial Statements*.

Answer to Interactive question 12

Asset revaluation

Situation A – Asset is not revalued

Statement of profit or loss and other comprehensive income

	20X4	20X5	20X6	20X7
	£'000	£'000	£'000	£'000
Profit from operations				
Includes depreciation of	(6)	(6)	(6)	–
Profit on disposal of property, plant and equipment	–	–	–	43

Total impact on reported profit for 20X4 to 20X7 = £25,000 = proceeds of £127,000 less carrying amount of £102,000 at 1 January 20X4

Statement of financial position

	20X4	20X5	20X6	20X7
	£'000	£'000	£'000	£'000
Carrying amount of asset at year end	96	90	84	–
(included in capital employed)				

Situation B – Asset is revalued

Statement of profit or loss

	20X4	20X5	20X6	20X7
Profit from operations	£'000	£'000	£'000	£'000
Includes depreciation of	(8)	(8)	(8)	–
Profit on disposal of property, plant and equipment	-	-	-	15

Total impact on reported profit for 20X4 to 20X7 = £(9,000)

Other comprehensive income

	20X4	20X5	20X6	20X7
	£'000	£'000	£'000	£'000
Gain on revaluation of property, plant and Equipment	34	–	–	–
Gain is not reported as part of profit				
Therefore not included in earnings for any year				

Statement of financial position

	20X4	20X5	20X6	20X7
	£'000	£'000	£'000	£'000
Carrying amount of asset at year end (included in capital employed)	128	120	112	–

Summary

	Situation A No revaluation £'000	Situation B Revaluation £'000
Aggregate impact on earnings (20X4 to 20X7)	25	(9)

Answer to Interactive question 13

Changing payment dates

		Current ratio	Quick ratio
Option 1	(1,600 ÷ 1,000) and (1,100 ÷ 1,000)	1.60:1	1.10:1
Option 2	((1,600 + 300) ÷ (1,000 + 300)) and ((1,100 + 300) ÷ (1,000 +300))	1.46:1	1.08:1
Option 3	((1,600 – 300) ÷ (1,000 – 300)) and ((1,100 – 300) ÷ (1,000 – 300))	1.86:1	1.14:1

Answer to Interactive question 14

Ethical pressures Motivations

(1)	The new Managing Director (MD) is motivated to try to maximise the post-acquisition earnings from the target company. This will help to increase EPS and the acquisition may be perceived as more successful
(2)	If asset carrying amounts are reduced at the date of acquisition, then goodwill will be increased by the same amount. Goodwill is not amortised and, assuming no impairment occurs in the immediate post-acquisition period, the effect on earnings from increasing goodwill will be nil
(3)	By reducing the asset carrying amounts, the depreciation and amortisation expense related to non-current assets will be reduced in the post-acquisition period, as will inventory amounts charged to cost of sales. If asset carrying amounts were increased, the opposite would occur and post-acquisition earnings would be adversely affected

(4)	Accounting standards such as IFRS 3 and IFRS 13 are clear in the determination and treatment of the fair values of the acquired assets, liabilities and contingent liabilities. However, judgement is still required in determining fair values. It is essential that an unbiased approach be used in applying the judgement necessary. IFRS 13 has eliminated some of the subjectivity.

Actions to consider

(1)	The MD should be made aware of the issues involved, including the potential professional and legal issues. The requirements of the relevant accounting standards should be explained to her.
(2)	It may be appropriate to discuss and explain the situation to other members of the board of directors and to seek their opinions. They may be able to add support.
(3)	If the MD continues to try to dominate and exert influence on the contents of the report, then it would be appropriate to consult the ethical handbook, the local district society support member and/or the confidential ethics helpline
(4)	The approach of the MD may raise concerns about her ethical approach to business in areas other than financial reporting. It is important to remain alert to other potential areas of inappropriate practice. Ultimately the domineering approach of the MD may lead to the conclusion that alternative employment should be sought.

Answers to Self-test questions

1 Wild Swan

1.1 Capital employed and gearing

Calculations of ratios	20X3	20X2
ROCE = Profit before interest and tax ÷ Capital employed	728 ÷ (4,613 + 105 + 1,442 – 386) = 12.6%	669 ÷ (2,598 + 1,183 – 3) = 17.7%
Gearing = Net debt ÷ Equity	(105 + 1,442 – 386) ÷ 4,613 = 25.2%	(1,183 – 3) ÷ 2,598 = 45.4%

1.2 Commentary on financial performance and position Profitability

The overall profitability of the company has remained stable, with a constant net margin and a slightly increased gross margin offset by increased overhead costs. Revenue growth of 10.5% ((24,267/21,958) – 1) has been achieved without an adverse effect on the net margin.

The drop in ROCE from 17.7% to 12.6% is due to the asset revaluation in 20X3. If the revaluation surplus is removed, the comparison between the years is much more valid.

Asset turnover and ROCE may be artificially high due to the company's plant being old and therefore heavily depreciated. This is suggested by the large depreciation charge on plant (as a percentage of carrying amount). Alternatively, this together with the major investment in replacing assets could indicate that plant has a relatively short life.

Liquidity and working capital management

For a manufacturer the trade receivables collection period appears satisfactory, though it has increased by six days compared with 20X2. This may be due to the increased sales volume, possibly encouraged by easier credit terms.

The current and quick ratios both appear low, though they have improved compared with 20X2. This appears to be due mainly to the large and increasing bank overdraft and to trade payables, which have increased by 18% compared with revenue growth of 10.5%.

Seasonal factors may have distorted the liquidity position, for example because the business has built up inventory to meet a sales peak shortly after the year end. This would tend to increase trade payables and overdrafts. Interest expense amounts to only 6% of the average overdraft, which suggests that the year-end balance is high relative to the year as a whole.

The decision to hold large amounts of cash, when the company has a bank overdraft equating to 25% of net assets, appears to lack business logic, unless the amounts for some reason cannot be set off against each other.

Long-term solvency

The company made a share issue for £168,000 in the year. It has very little non-current debt, having issued only £105,000 in 20X3 and having none in issue in 20X2, but it does have significant overdrafts. Although the gearing ratio of 25.2% appears acceptable, it has been reduced by the asset revaluation.

Even if the debt was issued just before the year end (and therefore would not have had much effect on the amount of interest charged), the group has high interest cover and could finance more non-current debt. If the business does need debt financing on an ongoing basis (rather than as a result of seasonal factors), it would probably be cheaper to obtain this via long-term loans, rather than maintaining a large overdraft. This would also improve the company's short-term liquidity position.

Cash flow analysis

Operating cash inflows of £1,208,000 compare favourably with operating profits of £728,000. If non-current asset replacement cash flows are deducted, the resulting net operating cash inflow falls to £468,000 (1,208 – 740). This is still more than adequate to finance £82,000 taxation, £67,000 interest and £12,000 preference dividends, leaving £307,000 available for more discretionary use.

£468,000 was paid out in equity dividends, representing 147% of available cash flows before financing (468 as a percentage of (1,059 – 740)). The excess was funded by the share issue/borrowings. This level of dividends places an unnecessary strain on the company's cash position and, if maintained, may lead to insufficient reinvestment to maintain operations.

The gearing of 25.2% is unlikely to threaten long-term solvency but the company would nevertheless benefit from reducing its overdraft in favour of less costly forms of finance.

The cash flow ratios given help analyse the cash amount of:

- return on capital employed
- interest cover

These cash flow ratios eliminate non-cash items such as accruals from the traditional ratios.

The 22.1% cash return on capital employed (cash ROCE) for 20X3 is greater than the 12.6% traditional ROCE. In other words, the net assets generate more cash than profit. This is because the quality of profits is good (net cash inflow is greater than operating profit). Care should be taken in comparing these two ratios. Traditional ROCE includes depreciation, whereas cash ROCE excludes it, as it is non-cash. Depreciation is £965,000 which, if taken into account, more than counteracts this advantage.

Cash interest cover of 18 in 20X3 again compares favourably with the traditional interest cover of 10.9. Cash interest cover would be expected to be slightly higher, as it is also based on net cash flow from operating activities. Interest paid and payable in 20X3 both amount to £67,000 so there are no opening/closing accruals to consider.

Overall it would appear that Wild Swan Ltd has plenty of cash to cover its interest payments at the current time. Interest payable will increase next year if the borrowings were made just before the year end. Given the carrying amount of the non-current liabilities of £105,000 at 31 December 20X3 the interest payable next year should not dent either the interest cover or cash interest cover sufficiently to cause concern.

2 Reapson

Explanation:

(1) **Dividend – 15p per share**

This should be the cash amount of total dividends paid per share (in pence) in the most recent financial year. It ties in with the information provided, as it is the total dividend per the statement of changes in equity divided by the number of shares in issue, that is:

£81.75m ÷ (2 × 272.5m) = 15p per share

This is the absolute amount of the per share dividend paid out by the company. To be of any real meaning, it should be related to some other amount – see below.

(2) **Earnings per share**

This is the measure of the amount earned by the company on behalf of each ordinary share. Its amount is not influenced by the dividend distribution policy of the company, being a measure of earning capacity.

(3) **Dividend cover**

This gives an indication of the security of the dividend flow from the company, measured by reference to its current year profits. (In practice a company can cover dividends out of retained earnings.) If dividend cover is high, then the company is likely to be able to maintain the level of dividend payments even if earnings fall.

Dividend cover is calculated as earnings per share divided by net dividends per share. The impact of the exceptional closure costs (£40 million) and the increase in depreciation resulting from the current year revaluation (£17.5 million reserve transfer) has been to reduce earnings by £57.5 million. If these are added back, the earnings per share would become: (£222.9m + £57.5m) ÷ 545m = 51.4p

Revised dividend cover would therefore be:

51.4p ÷ 15p = 3.4 times

(4) **Dividend yield**

This gives an indication of the income return that an investor might expect on his or her shares. Because it is based on dividends, it too reflects distribution policy rather than earnings and performance.

The investor could use this to compare with returns on alternative investments.

(5) **Price/earnings ratio**

This is a way of measuring how highly investors value the earnings a company produces. It is therefore not affected by dividend policy.

Investors will pay more for shares now if they expect earnings to rise in the future, as these earnings will be reflected in future dividends and/or capital appreciation.

Using the adjusted EPS figure calculated above the ratio would be:

P/E ratio = Market price per share ÷ Earnings per share = 586p ÷ 51.4p = 11.4 times

3 Verona

3.1 Ratios using figures from the financial statements

	Nice Ltd	**Sienna Ltd**
Return on capital employed (ROCE)		
(Profit before interest and tax ÷ Capital employed) × 100	((149 + 10) ÷ (4,494 + 800 – 71)) × 100 = 3%	((609 + 5) ÷ (3,788 + 130)) × 100 = 16%
Trade receivables collection period		
(Trade receivables ÷ Revenue) × 89	(1,422 ÷ 3,000) × 89 = 42 Days	(1,731 ÷ 4,400) × 89 = 35 days

Trade payables payment period		
(Trade payables ÷ Purchases) × 89	(438 ÷ 1,500) × 89 = 26 days	(1,062 ÷ 2,100) × 89 = 45 days
Inventory turnover		
Cost of materials ÷ Average inventory	1,416 ÷ ((455 + 539) ÷ 2) = 2.8 times	1,935 ÷ ((684 + 849) ÷ 2) = 2.5 times

3.2 **Comparison of the two companies**

(1) **ROCE**

The managers of Nice Ltd are generating a far smaller return on the resources under their control than are the managers of Sienna Ltd. Sienna Ltd has produced a greater percentage return for each pound invested in the company than has Nice Ltd. This suggests that Sienna Ltd is using its net assets more effectively than Nice Ltd.

(2) **Trade receivables collection period**

Generally, the management of any company will try to obtain payment from credit customers as soon as possible. Sienna Ltd again outperforms Nice Ltd by receiving cash from customers seven days sooner on average.

(3) **Trade payables payment period**

In this case companies usually prefer to put off paying creditors for as long as possible to aid cash flow. Sienna Ltd has successfully managed to pay creditors an average of nineteen days later than Nice Ltd.

(4) **Inventory turnover**

As a further means of improving cash flow, companies try to turn over inventory as quickly as possible, avoiding working capital being tied up in slow-moving lines. Here, Nice Ltd is performing approximately 10% better than Sienna Ltd.

3.3 **Effect of information on Nice Ltd's ratios ROCE**

This will be affected by the revaluation and the purchase of new machinery.

The revaluation will have had a twofold effect on ROCE. It will increase capital employed by

£700,000 and reduce profit before interest and tax by additional depreciation of £7,000 (700,000 × 4% × 3/12).

Overall this will have reduced ROCE.

The purchase of the machinery will also have reduced ROCE due to capital employed increasing. The depreciation charge for just the last week of the period will not be sufficiently large as to distort comparisons.

Trade receivables collection period

The £300,000 receivable at some point in the future has artificially increased both trade receivables and the related collection period.

Trade payables payment period

The £400,000 will have been included in purchases used in the calculation of the trade payables payment period but as it was paid immediately it will not have been included in trade payables. The payment period will appear lower than it otherwise would have been.

3.4 Adjusted ratios

For ratio analysis to be meaningful, it is important to compare like with like. The managing director of Nice Ltd has good reason to feel that the ratio analysis carried out on the two sets of adjusted accounts results in misleading figures.

The group is intending to revalue the property of all group members. Until such time as figures are available for all the companies, an adjustment should be made to exclude revaluations from the ratios. Revaluation of property can result in a marked change in ROCE (as well as other asset-based ratios). The additional depreciation charge should also be added back to net profit.

The trade receivables collection period is normally used to analyse trade receivable payment profiles. Debts due from group companies, especially the holding company, may be subject to constraints outside the control of the receiving company, as in this case. As the holding company can dictate when the debt is paid, the directors of Nice Ltd should not be held answerable for this. Trade receivables should be reduced by £300,000.

The trade payables payment period should be calculated based on the ratio of trade payables to credit purchases. As the payment was made as soon as the goods were delivered, this amount should be treated as a cash purchase and excluded from the calculation.

4 Brass Ltd

4.1 Report as follows:

To: Managing Director

From: Financial Accountant

Date: 9 June 20X3

Subject: Comparative analysis of results with Alliance Breweries Ltd

I set out below my comments on the profitability and liquidity of Brass Ltd compared with those of our competitor, Alliance Breweries Ltd (Alliance). Equivalent accounting ratios to those already calculated for Brass Ltd have been calculated for Alliance and are set out in the Appendix.

Profitability

The fundamental profitability ratio ROCE for Brass Ltd is 25% and for Alliance 42.7%. It does therefore at first sight appear that Alliance has a better overall performance. Further analysis throws light on the reasons for this performance differential.

The ROCE can be subdivided into its two components: asset turnover and net profit margin.

The asset turnovers of Brass Ltd and Alliance are fairly similar (2.05 and 1.74 respectively). This ratio indicates how well a business is utilising its assets. Brass Ltd appears to be making slightly better use of its assets; that is, generating more revenue per pound of assets. This comparison assumes that the assets of the two businesses are comparable and, in particular, that the property, plant and equipment are comparable.

The major reason for the differing ROCE of the two companies would seem to be their different net profit margins. The net profit margin of Brass Ltd is 12.2% while that of Alliance is 24.5%. This is despite the fact that Brass Ltd has the better gross profit margin of 63.7% compared with 60.5% for Alliance. Since both companies operate in the same business, the gross profit percentage should be fairly similar and in fact the cost of sales figures are very similar. Brass Ltd appears to be able to sell its beer at higher prices. Possible reasons for this might include the following:

- A greater proportion of premium beer sales, such as real ale and more expensive lagers
- A greater proportion of higher added value goods, such as meals and accommodation
- A greater proportion of sales to the free trade at a higher margin (indicated by higher receivables)
- A better reputation and more longstanding customer base

  This favourable differential in the gross profit percentage is more than negated by Brass Ltd's substantially higher overheads which cause our company to have a considerably inferior net profit margin.

  Reasons for the differences in administrative and distribution costs include the following:
- Low depreciation (1%) of freehold hotels and public houses by Alliance (see below)
- Higher expenditure on advertising and promotion to establish the brands of Brass Ltd
- Directors of the two businesses earning substantially different salaries

In conclusion, Brass Ltd should be the more profitable business because of its higher gross margin. Overheads need to be carefully reviewed and reduced so that this is reflected in the net profit.

In particular, we must carefully review our advertising and promotion expenditure in comparison with Alliance. Currently Alliance spends considerably less than Brass Ltd because it has invested a substantial amount in the acquisition of well-established brands.

Liquidity

Brass Ltd has a current ratio of 1.4 and a quick ratio of 1.1, whereas Alliance has a current ratio of 1.5 and a quick ratio of 1.2. This would suggest that Alliance has slightly better liquidity; however, the figures may not be strictly comparable due to the different trading strategies.

Brass Ltd has inventory turnover of 8.1 compared with 13.8 for Alliance. This suggests that either Brass Ltd is overstocked or possibly that we hold a greater number of inventory lines. This greater range of products may to some extent account for our higher prices and gross margin. In either case, a serious review of stockholding policy is necessary to remedy any deficiency and to optimise the strategy.

The trade receivables collection period for Brass Ltd stands at 65 days, about a week slower

than Alliance at 58 days. This is probably due to our higher proportion of customers buying on credit.

Brass Ltd has a £20 million loan in issue which is due for repayment in 18 months. As you are aware, that is why we are accumulating our cash balance which currently stands at

£5,102,000. Hopefully, by the redemption date, we will have sufficient cash to redeem the debt.

In summary, the liquidity positions of the two companies appear fairly similar except that Brass Ltd has to be able to generate sufficient funds to repay its loan in 18 months. To facilitate this the company needs to reduce its inventory levels so that the inventory turnover ratio is closer to that of Alliance, and also to improve credit control to reduce the trade receivables collection period. Improved cost control, as mentioned above under profitability, should also have positive benefits.

4.2 **Adjustments required to the financial statements of the two companies for a more relevant comparison of their relative performance**

(1) **Depreciation of freehold buildings**

The freehold buildings of Alliance Breweries Ltd are being depreciated over 100 years as opposed to our 25 years. This has a significant impact on the depreciation charge and therefore on profit. We should review our depreciation policy for buildings.

(2) **Revaluation of land and buildings**

Either eliminate the revaluation and associated depreciation from the Brass Ltd accounts, or revalue the land and buildings of Alliance Breweries on a similar basis. Either adjustment would have the effect of improving the ROCE of Brass Ltd relative to that of Alliance.

(3) **Intangibles**

Write off the intangibles and associated amortisation from the accounts of Alliance. This would have the effect of reducing the ROCE of Alliance.

The net effect of the three adjustments would be to improve the ROCE of Brass Ltd relative to that of Alliance Breweries Ltd.

Appendix – Ratio analysis for Alliance Breweries Ltd

(1) ROCE = Profit before interest and tax ÷ Capital employed = 35,123 ÷ (82,080 + 150) = 42.7%

(2) Asset turnover = Revenue ÷ Capital employed = 143,100 ÷ (82,080 + 150) = 1.74

(3) Net profit margin = Profit before interest and tax ÷ Revenue = 35,123 ÷ 143,100 = 24.5%

(4) Gross profit percentage = Gross profit ÷ Revenue = 86,600 ÷ 143,100 = 60.5%

(5) Current ratio = Current assets ÷ Current liabilities = 26,840 ÷ 18,260 = 1.47

(6) Quick ratio = Current assets ÷ Current liabilities = 22,738 ÷ 18,260 = 1.25

(7) Trade receivables collection period = Trade receivables ÷ Revenue = (22,738 ÷ 143,100) × 365 = 58 days

(8) Inventory turnover = Cost of sales ÷ Inventory = 56,500 ÷ 4,102 = 13.8

5 Caithness plc

5.1 Commentary on relative financial performance and position

Manufacturing companies tend to have a lower return on their capital employed (ROCE) than non-manufacturing, due to their higher capital base.

However, Sutherland Ltd's ROCE is significantly lower than that of Argyll Ltd. The revaluation of Sutherland Ltd's freehold property will be a factor if it resulted in an uplift of asset values. This would:

- increase the depreciation charge and reduce the return; and
- increase capital employed.

However, Argyll Ltd's ROCE will probably decrease once the lease has been properly accounted for; the right-of-use asset will probably increase capital employed by a greater relative amount than the replacement of lease rentals by depreciation will increase profit. (The finance cost element of a lease is presented within finance charges, below the profit before interest and tax.)

Although the gross profit percentage of Sutherland Ltd is less than that of Argyll Ltd:

- the net margin is higher – indicating overhead costs are higher in Argyll Ltd; but
- Argyll Ltd's rental costs with regard to the lease are recognised at present in profit or loss, which is not permitted under IFRS 16.

The current and quick ratios look healthy, as they are all well in excess of 1:1. Sutherland Ltd appears to hold more inventories than Argyll Ltd. This is evident from:

- the higher number of days in inventories; and
- the fall from the current to the quick ratio for Sutherland Ltd is greater than for Argyll Ltd.

Sutherland Ltd has more money invested in working capital than Argyll Ltd. This is evident from:

- a higher trade receivables collection period (although this is artificially high, as another group company accounts for £200,000);
- a lower trade payables payment period; and
- a higher inventory turnover period – though Argyll Ltd's inventory looks very low for a manufacturing company.

Argyll Ltd has a higher gearing ratio than Sutherland Ltd and, probably as a consequence of this, a lower interest cover. Both these ratios will worsen once the lease is correctly accounted for.

Argyll Ltd could have raised some finance in the year, though this might be unlikely given that Argyll Ltd has leased equipment recently.

Cash ROCE relates operating cash flow to the same capital as in ROCE. It would appear that Sutherland Ltd is more efficient than Argyll Ltd at turning operating profits into cash, as cash ROCE is higher than ROCE for Sutherland Ltd and lower for Argyll Ltd.

However, it is not clear what the effect of the lease capitalisation will be on Argyll Ltd's cash ROCE. The cash generated from operations (the numerator in the calculation) will rise as the lease payments are added back, but so will capital employed (the denominator). The effect on cash ROCE depends on the relative changes in each.

Short-term liquidity may be more of an issue for Sutherland Ltd, given its higher working capital ratios.

The effect of dividend policy also needs to be considered, as this could affect a number of ratios.

5.2 **Further information needed with reasons**

- The particular manufacturing sector in which the group operates – would help to provide sector comparatives.
- Comparatives for the same period in the previous year – would help to provide a benchmark for each company.
- Actual statements of comprehensive income and of financial position for each company – to judge the effect of the revaluation, the lease and the £200,000 receivable. Specific amounts would be needed for the revaluation and the lease.
- Cash flow information to establish:
  - whether Sutherland Ltd may have short-term liquidity problems from high working capital ratios; and
  - whether Argyll Ltd has raised any finance in the year.
  - Details of any dividend distribution.

5.3 **Commentary in the light of the managing director's knowledge**

Certain facts regarding the managing director of Argyll Ltd now appear to be suspicious.

- He was previously the head of the (combined) accounts department and may still be in a position to exert influence.
- Once Argyll Ltd's lease has been correctly recognised, its ROCE will decrease but its gross profit percentage and net margin will increase. Although at the moment its ROCE and gross profit percentage compare favourably with Sutherland Ltd, its net profit percentage does not.
- Sutherland Ltd appears to be taking longer to collect its debts than Argyll Ltd – this is in part because of the inter-group sale arranged at the instigation of Argyll Ltd.

The following information would be useful to confirm the legitimacy of items listed under Additional information (2) to (4).

- The reasons behind the revaluation
- The details of the lease, for example whether there are lease incentives or deposits which should be included in the value of the right-of-use asset
- Whether the inter-group sale really was to the benefit of Sutherland Ltd (for example sale made at a profit) or a transaction engineered by Argyll Ltd's managing director
- Whether the managing director of Argyll Ltd has any other motive to improve Argyll Ltd's figures (shareholding, bonus, and so on)

6 Trendsetters Ltd

6.1 Cash flow ratios

	20X2	20X1
Cash ROCE		
(Cash return ÷ Capital employed) × 100	869 ÷ (7,152 + 1,500 – 3,742)	(882 + 55) ÷ (4,872 + 1,000 – 910)
	= 869 ÷ 4,910 = 17.7%	= 937 ÷ 4,962 = 18.9%
(Cash from operations ÷ Profit from operations) × 100	869 ÷ (2,293 + 165)	882 ÷ (162 + 102 – 55)
	= 35.4%	= 422%
Cash interest cover		
Cash return ÷ Interest paid	869 ÷ 165 = 5.3 times	(882 + 55) ÷ 102 = 9.2 times

Commentary

- The slight fall in the cash ROCE from 18.9% to 17.7% shows that the company's efficiency is falling. This is confirmed by a more dramatic fall in the net asset turnover from 0.63 (3,102/(4,872 + 1,000 – 910)) to 0.45 (2,201/(7,152 + 1,500 – 3,742)).
- Although on the face of it the company has made a much higher profit before tax in 20X2 (£2,293,000) compared with 20X1 (£162,000), this 20X2 profit before tax includes a one-off £1,502,000 profit on disposal of PPE.
- This is further illustrated by the decline in the ratio of cash from operations to profit from operations, which has fallen from 422% to 35.4%. The quality of Trendsetters Ltd's profits is clearly falling.
- Cash interest cover has fallen from 9.2 to 5.3. This is partly because the cash return has fallen slightly (from £937,000 to £869,000) but mainly because of the increase in interest paid from £102,000 in 20X1 to £165,000 in 20X2.
- Interest paid has increased by 62% over the year, yet borrowings have increased by only 50%. It may be that the company is now having to pay higher interest rates to compensate lenders for increased risk, perhaps due to shorter-term or unsecured borrowings.
- The disposal of stores, which has led to a profit of £1,502,000 (presumably because of low carrying amounts and properties held for some years), may indicate the presence of a well thought out restructuring plan which could save the company. However, this seems

unlikely as the company's interpretation of fashion trends is likely to be equally well or badly received whatever the location of its stores.

- The sale of the stores therefore looks to be a short-term measure to boost the company's cash resources. Whether this will help the company in 20X3 and beyond depends on how the proceeds of sale are used. If the proceeds are used to acquire a more successful chain of stores or more up to date expertise, the company's real profitability could improve.
- Other factors indicate similar short-termism.

- Long-term investments have been sold, boosting cash in 20X2 by £32,000 but at the expense of dividends received of £55,000. This sale also made a loss of £101,000, indicating that the original investments were bought when stock markets were higher.
- The statement of cash flows shows that trade and other payables have risen very substantially during 20X2 (and by a lesser amount in 20X1). This indicates either an inability to pay suppliers (the cash injection from the sale of stores was close to the year end and opening cash only £122,000) or an unwillingness to do so. Pressing suppliers for extended credit terms could lead to a loss of goodwill and ultimately a refusal to supply.
- No dividends were paid in 20X2, indicating that the company's cash resources were low.
- Inventories have increased significantly over the year. This may indicate the holding of obsolete inventories which should be written down.
- Overall, the company appears to be struggling to survive long term, despite the substantial cash balances, and investors should be looking for a change in leadership of the design department to take the company forward with a smaller number of stores.

6.2 Pressure to improve the figures

There are several short-term devices which improve short-term performance and/or position, many of which could have been used at Trendsetters Ltd.

- A company could 'window-dress' its cash position by taking out borrowings just before the year end, which it then repays early in the next accounting period.
- The sale of assets (as here, with the disposal of stores) just before the year end will improve the cash position in the short term but the impact of selling any profit generating assets will not have a detrimental effect on profits until the following year.
- Borrowings taken out close to the year end will not impact on interest payable and profit until the following period.
- In areas where management have to make judgements, for example the level of inventory, the recoverability of receivables or the level of impairments in respect of tangible or intangible assets, it is always possible for an unscrupulous manager to justify lower write-offs than are really needed.
- The timing of payments to suppliers can improve the trade payables payment period.
- Sales may be made in the last few weeks of the year, but no provision made for returns (a provision which should be made in Trendsetters Ltd if it allows customers to return for refunds, as many fashion stores do).

Actions

In response to such pressures, the financial controller should:

- consider his own professional position and the ethics of the situation;
- outline the issues to the operational directors and propose solutions that comply with laws and standards; and
- contact the ethical helplines maintained by the professional bodies.

Chapter 24

Financial statement analysis 2

Introduction

Introduction

Learning outcomes

- Appraise the nature and validity of financial and non-financial information included in published financial statements including how these correlate with an understanding of the entity
- Evaluate and appraise the nature and validity of information disclosed in annual reports, including integrated reporting and other voluntary disclosures, including those relating to natural capital sustainability and climate change
- Appraise the limitations of financial analysis
- Analyse and evaluate the performance, position, liquidity, efficiency and solvency of an entity through the use of ratios and similar forms of analysis including using quantitative and qualitative data
- Interpret the potentially complex economic environment in which an entity operates and its strategy based upon financial and operational information contained within the annual report (for example: financial and business reviews; reports on operations by management, corporate governance disclosures, Climate-related Financial Disclosures, financial summaries)
- Appraise the significance of inconsistencies and omissions in reported information in evaluating performance using audit data analytics software
- Compare the performance and position of different entities allowing for inconsistencies in the recognition and measurement criteria in the financial statement information provided
- Evaluate the performance of an entity using accounting information in data analytics software using appropriate data analysis tools, including excel file, to interpret and present conclusions
- Construct adjustments to reported earnings in order to determine underlying earnings and compare the performance of an entity over time
- Analyse and evaluate business risks and assess their implications for corporate reporting
- Analyse and evaluate financial risks (for example financing, currency and interest rate risks) and assess their implications for corporate reporting
- Compare and appraise the significance of accruals basis and cash flow reporting
- Determine analytical procedures, where appropriate using appropriate data analysis tools, at the planning stage using technical knowledge of corporate reporting, data analytics software and skills of financial statement analysis
- Design and determine audit procedures in a range of circumstances and scenarios, for example identifying an appropriate mix of tests of controls, analytical procedures and tests of details
- Evaluate, quantitatively and qualitatively, using analytical procedures and appropriate data analysis tools, the results and conclusions obtained from audit procedures

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
1	**Objectives and scope of financial analysis** As a Chartered Accountant you need to appreciate the importance of disaggregated information as a basis for financial analysis, performance evaluation and decision making.	**Approach** This is a short chapter overview – read it quickly.	This topic is not examined.	N/A
2	**Business strategy analysis** This chapter brings together elements of your study from your whole Workbook, aspects of financial management and business strategy and your study of financial ratios from previous Chapter.	**Approach** This material should be familiar to you from your Professional Level studies of business strategy. **Stop and think** The emphasis in this section is on competitiveness.	This material is for background only. It has not been examined to date.	N/A
3	**Accounting analysis** This section builds on the material in previous Chapter, but looks at it from a different angle. For example, choice of accounting policy is discussed in terms of whether it is compatible with business strategy.	**Approach** Focus on paragraph 3.1.3, which shows the spectrum of creative accounting from legitimate to outright fraud. **Stop and think** Why would creative accounting be used?	Creative accounting can come up in an integrated question in the context of audit, for example potential window dressing.	N/A
4	**Accounting distortions** You should be aware of the difficulties in interpreting financial information as a result of the flexibility	**Approach** Distortions occur mainly in assets, but also liabilities and equity. The scope for distortion has been restricted by	Now that the scope for distorting revenue has been restricted by IFRS 15, you may get a question where IFRS 15 has not	N/A

CHAPTER 24

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
	afforded by certain standards and the potential misrepresentation of such information.	recent standards, but not eliminated. **Stop and think** Which recent standards have reduced scope for accounting distortions?	been followed.	
5	**Improving the quality of financial information** Having shown how financial information can be distorted in the previous section, we go on in this section to show ways of undoing the distortion by making key adjustments.	**Approach** Key adjustments are made to undo distortions and standardise the financial statements. These include adding back off balance sheet items and revaluing assets to fair value. **Stop and think** Assets may be understated as well as overstated.	As mentioned in the previous chapter, you may need to adjust financial statements of a potential acquisition to achieve comparability and to make an informed decision as to whether to go ahead.	N/A
6	**Financial ratios interpretation** Building on material in previous Chapter, this section goes into more depth regarding problems with interpreting financial ratios.	**Approach** Pay particular attention to the paragraphs on 'profit margin – the base data' and the factors that determine the line-items that go into the ratio. Finally we revisit cash flows in depth. **Stop and think** This is where strategy and accounting meet.	In an exam you are much more likely to be given financial ratios to interpret or correct in the light of adjustments you have made.	N/A
7	**Forecasting performance** This section considers how we forecast financial statements and analyse the impact of	**Approach** Forecasting will never be an exact science, but it is helped by: Analysing and re-stating the existing	It is unlikely that the emphasis will be on preparing forecasts in an exam. However, you may need to adjust an existing forecast in	**IQ1: Forecasting revenue** A short question, presupposing that the assumptions are correct. **IQ2: Forecasting**

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
	business decisions on the value of a company.	accounts where necessary. Understanding the business model. **Stop and think** Again, this is where strategy and accounting interact.	the light of corrections made to the current period's financial statements.	**capital expenditure** This question asks for your judgement on which financial ratio to use.
8	**Data and analysis** This section introduces the topic of data and analysis. In a later chapter, this is looked at more formally in the context of data analytics, a specialised aspect of data analysis.	**Approach** Focus on the worked example, which has ratios already calculated. You can test yourself by covering up the analysis part and trying it yourself. **Stop and think** Is it possible to have too much data?	You may be given several years' worth of data to analyse. Data analytics (see later chapters) has started to be examined recently.	N/A
9	**Management commentary** The limitations of financial statements and financial ratios led to the requirement for a management commentary.	**Approach** Read through the whole of this short section. **Stop and think** The management commentary is a link between past and future performance.	A recent exam question tested the management commentary in the context of analytical procedures to identify the risks of misstatement.	N/A
10	**Summary** This has been a long chapter, so a summary is provided to help you put the issues in perspective.	**Approach** Read and highlight – you can use this for revision. **Stop and think** How can accounting ratios help with forecasting?	This summary section would not be specifically examined.	N/A
11	**Audit focus on fraud** Following on from the creative accounting issues raised in this chapter,	**Approach** Learn the definition of fraud. It is not the same thing as sharp practice.	This is a likely topic, because it links financial reporting, audit and ethics.	**IQ4 and 5** These questions are interlinked. Having raised issues at the audit planning

Topic	Practical significance	Study approach	Exam approach	Interactive Questions
	this section deals with fraud. Not all creative accounting practices are fraudulent, but most can be considered 'red flags' and should alert the auditor to potential fraud.	Focus on the section on aggressive earnings management, which links in with creative accounting discussed earlier. **Stop and think** Why would management try to manipulate profits to appear lower than they are?		meeting regarding the risk of fraud, the auditor has to consider the information it wants from the client.

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Objectives and scope of financial analysis

Section overview

Financial analysis is the process through which the stakeholders of a company, such as shareholders, debt holders, government and employees, are able to assess the historical performance of the company and form a view about its future prospects and value.

Financial analysis involves the following:

- The evaluation of a firm's business strategy, risks and profit potential
- The assessment of a firm's accounting policies and its conformity to its business strategy
- The evaluation of a firm's current and future performance and its long-term prospects
- The prediction of a firm's future performance

2 Business strategy analysis

Section overview

This section analyses the business strategy of a firm by looking at the industry in which the firm operates, the competitive positioning of the company and the organisational structure and wealth creation potential.

2.1 Business strategy analysis

A company can claim to create value if the rate of ROCE exceeds its weighted average cost of capital (WACC). The WACC is the return that the capital contributors to a company, ie, its equity and bond holders, require and is determined in the financial markets. Thus the WACC is largely exogenous to the management of a firm. (This has been discussed in your Strategic Business Management Workbook.)

The ROCE, on the other hand, is largely determined by the management of the company and is a reflection of the decisions that management has made with regard to investment, production and pricing policies, as well as the structure of the industry in which the company operates. A company that operates in a highly competitive industry has less freedom to raise prices than a company that operates in a less competitive industry. Similarly, investment in research and development will allow a firm to produce more innovative products, to create patents and so on.

The various aspects of the operation of a firm that determine its return on capital will be investigated in three stages. The first stage involves the investigation of the profit potential of the industry in which a firm operates. The second stage will investigate the competitive positioning of a firm within a given industry. The third stage investigates the sources of value of a particular firm.

2.2 Industry analysis

It is a fact of life that different industries have different rates of profitability. Industry analysis deals with the analysis of the factors that determine the profit potential of a particular industry. Since profit is the difference between revenues and costs, and since price setting in the output or input markets depends on the competitive structure of each market, industry analysis explains the profitability of an industry by the degree of competition in the industry. The degree of competition within an industry depends on:

- the degree of rivalry between the firms of an industry;
- the barriers to entrance into the industry;
- the substitutability of the industry's products;
- the price elasticity of the industry's products; and
- the structure of the input markets.

2.2.1 Degree of rivalry

In some industries such as retailing, firms compete aggressively by cutting prices, whereas in other industries such as those involving services, there is less aggressive competition through prices, and the competition takes the form of branding or some other distinctive product differentiation. An example of a company that does not compete on price, but on product differentiation would be a company that makes bespoke hand-crafted furniture. The factors that determine the degree of rivalry are as follows:

(a) **The growth rate of the industry**: If the demand for the products of an industry grows rapidly, then revenues can grow through expanding production, without the need to cut prices. If on the other hand the growth in demand for the products of the industry grows slowly, then firms may be inclined to compete on price. Similarly, in a low growth situation, excess capacity in the industry may force prices down.

(b) **The number and relative size of the firms in the industry**: The number of firms in an industry determines the ability of firms to collude, as it is easier to co-ordinate price fixing when the number of players is small. In addition, where there is a small number of equally sized companies, then the companies can simply collude to divide up the market without any pressure on the prices. When an industry consists of a large number of different sized companies, then price competition is more likely. The airline industry is a good example of a fragmented market with high degree of price competition.

(c) **The degree of product differentiation in the industry**: Industries which allow product differentiation at low costs will also tend to compete on non-price terms, as differentiated products are imperfect substitutes and therefore less sensitive to price changes.

(d) **The existence of scale economies**: Scale economies exist when average production costs fall as the scale of operation of a company increases. Thus larger firms can reduce costs because of larger cost efficiencies and in order to achieve this larger size they may have to cut prices to increase production.

(e) **The degree of operating leverage**: The operating leverage of a firm measures the ratio of fixed costs to variable costs at a given level of output. When the degree of operating leverage is high companies may be inclined to reduce prices to expand the operations and thus use more the fixed factors of production that give rise to fixed costs.

(f) **Capital specificity**: If there is excess capacity in an industry, an alternative to cutting prices is for a company to leave the industry and move into a different industry. However, the ability to do this may be limited by the specificity of the capital (human and physical) to an industry and the heavy costs of converting the existing capital for a different use.

2.2.2 Barriers to entrance

Barriers to entrance make it difficult for new entrants to enter an industry and to increase competition. The main barriers to entrance are as follows:

(a) The **minimum size of operation**: In many industries there is a minimum size of operation that only a small number of firms can attain.

(b) **Early entry advantage**: In certain industries the first entrant generates an advantage that makes it difficult for other entrants. An example is a company that has secured for a number of years the supply of material.

(c) **Distribution channels**: In certain industries distribution channels are controlled by competitors and it is therefore difficult for the products to reach the consumer.

(d) **Regulation and legal constraints**: There may be regulations that prevent the entry into a specific industry of companies unless they meet certain requirements.

2.2.3 Product substitutability

For a number of industries there are substitute goods and the degree of substitutability affects the price-setting behaviour of the entire industry. While there is some degree of substitutability between cars and bicycles, it is unlikely that many car users will switch to cycling. Public transport on the other hand is a closer substitute and it is much easier for motorists to switch to public transport.

2.2.4 Price elasticity

The price elasticity of the demand for the products of an industry is also an important factor in the determination of the industry structure. The price elasticity measures the sensitivity of demand changes in the price of a product. When demand is highly sensitive to price changes, then companies may not be able to increase revenues by raising prices, since this will be offset by a fall in the demand.

The price sensitivity of a product also depends on the number of buyers of the product. Where the number of buyers is small, a firm may be in a weak position. Firms that sell their products to the public sector are in a particularly weak position, as there is no alternative market for their products.

2.2.5 The structure of the input markets

The structure of the input markets determines the price that firms pay for their inputs. In markets where there is a larger number of suppliers it is easier for a firm to negotiate lower prices.

2.3 Competitive analysis

In the previous section we analysed the factors that affect the structure and consequently the profitability of an industry. In this section we shall discuss the factors that determine the positioning of a firm within a given industry.

There are basically two options that a firm has in deciding where to position itself relative to the industry in order to create a competitive advantage. The first option is to produce at a lower cost than the other firms in the industry. The second option is to produce products that are sufficiently differentiated so as to be less sensitive to prices.

2.3.1 Low cost strategy

A low cost strategy can be achieved by a company through the following:

(a) **Economies of scale**: As we discussed above, economies of scale exist when the cost of production per unit of output decreases as the level of production increases. Thus companies which reach a certain size may be able to follow a low cost strategy.

(b) **Economies of scope**: Economies of scope exist when the average cost per product decreases as the number of products produced by the company increases. This is due to the existence of fixed factors of production which can be used more efficiently when used by a larger number of products. The attainment of economies of scope is sometimes the main reason for the merger of companies.

(c) **Efficient organisation and production**: The efficient organisation of a company which reduces duplication of responsibilities, and reduces operational costs, as well as the adoption of more efficient production methods may also lead to lower costs.

(d) **Lower input costs**: If a firm can achieve lower input costs because it has for instance monopsonistic power, then the firm can achieve lower costs of production.

2.3.2 Product differentiation

The second strategy for the creation of competitive advantage is through **product differentiation**. As we already discussed in the previous section, product differentiation reduces the competitive pressure on a firm and thus it allows for greater profitability.

Product differentiation can take several forms, such as branding, product quality, product appearance, delivery timing, terms of purchase or service, after-sales service and so on.

2.3.3 Assessing a competitive strategy

An understanding of a company's strategy will require, among other things, an appreciation of its key success factors and risks. One aim of financial analysis is to evaluate how well the company is managing these factors.

For example, in the pharmaceutical industry, a key factor for success might be the number of new drugs brought to the market through the research and development (R&D) process. Expenditure on R&D might be one factor to indicate the extent of the R&D process. While expenditure does not guarantee successful products, any changes in expenditure might be indicative of longer-term commitment.

Further examples might be the level of bad debt write-offs on loans for banks and the level of warranty provisions for any company where product quality is a key indicator.

A key factor in financial analysis is evaluating a company not just in isolation but by comparison with its competitors. Where companies in the same industry adopt different accounting policies, analysts may need to apply adjustments to the financial statements in order to compare like with like.

This does not, however, mean that all companies in the same industry should have the same accounting policies, and the same measurement bases. Similarly, a company might make lower warranty provisions or bad debt write-offs than other companies in the industry. This might be through imprudent accounting, or because the company in question has better quality products and better credit management. An analyst's judgement and wider knowledge of the company is needed rather than a blanket adjustment to adopt the same accounting policies for all companies in the industry.

2.4 Corporate strategy and sources of value

The third step of business analysis deals with the investigation of the sources of value of the firm. We have already discussed that value is created when the ROCE exceeds the WACC, and the factors that affect an industry's ROCE which is in a sense a constraint but also an estimate of the ROCE for an individual firm. We have also covered the two strategies which firms adopt in order to maximise their ROCE. In this last session of competitive analysis, we look at how the structure of a firm and its corporate strategy affects its ability to create value.

2.4.1 The structure of a firm

A firm will be able to create value only if it is efficiently organised. The exact organisation of a company will depend on the transaction costs which are incurred in carrying out transactions which are related to the operations of a firm. The theory that underpins this view of corporate organisation is the transaction costs theory of the firm which postulates that firms are formed because transaction costs within an organisation are lower than the costs of transacting through the markets. Depending on the nature of the business, an organisation may reduce its transaction costs by engaging in multiproduct production instead of producing a single product. This rationale underpins the diversification of, for example, the banking industry into other areas such as insurance and securities trading.

2.4.2 Assessing value creation ability

How do we assess whether the organisational structure of a particular firm generates value? The fundamental test is whether transaction costs within a firm are higher than in the market. An example of a situation where value is created by resorting to the market is outsourcing. A second test is the existence of scope economies which can be exploited to reduce costs and create value. Economies of scope are generated by the more intensive use of a fixed factor of production. Such a fixed factor of production could be a brand name, a unique delivery channel etc. The third test is the existence in a company of mechanisms that reduce agency costs. If a company passes all three tests then it is highly likely that the company has the ability to generate value.

3 Accounting analysis

Section overview

This section analyses the sources of financial information that are needed for the financial analysis of a company and the steps that need to be taken in order to identify potential problems and resolve them.

3.1 Scope of accounting analysis

The second stage of financial analysis is the evaluation of the accounting policies of the company and their conformity with the business strategy of the firm. Accounting analysis involves the following steps:

- Evaluation of key accounting policies
- Evaluation of disclosure quality
- Identification of 'red flags'
- Elimination of accounting distortions

3.1.1 Evaluation of key accounting policies

An assessment needs to be made as to whether the accounting policies adopted attempt to inflate or deflate earnings and asset values in a systematic way. If, where options for accounting policies exist, the directors have always selected the option that inflates profits, then there may be concerns over the quality of the reported earnings measure and whether it reflects (or distorts) underlying cash flows and economic circumstances.

Companies also have to exercise judgement and make assumptions in the application of accounting policy. Assumptions include, for example, figures for employee turnover, mortality rates and future increases in salaries (if these will affect the eventual size of future benefits such as pension payments).

3.1.2 Evaluation of disclosure quality

Good quality disclosure makes it easier for valid financial analysis to take place. While relevant IFRSs set a minimum level of disclosure, there is nothing to prevent companies disclosing more than the minimum. Indeed, many would expect a management keen on accessing capital markets to provide full disclosures of key information, whether or not these were required by accounting standards.

Consideration might be given to the following:

- Whether any disclosure is made in addition to the minimum required by accounting regulations
- Whether the company has taken advantage of any exemptions from disclosure in accounting standards, or produced the bare minimum disclosure
- Whether additional disclosure is quantitative and detailed; or alternatively qualitative and only indicative
- Whether the information is disclosed in the notes to the financial statements and thus subject to a statutory audit; or only in the accompanying information in the annual report and therefore only subject to review
- The details in the supplementary statements, which are largely unregulated (such as in the operating and financial review) and whether they provide an adequate explanation of current performance
- Where alternative performance measures are used, clear explanations of the reconciling items to the amounts in the financial statements
- Whether unusual items and policies are adequately explained and justified
- Clear explanations of any uncertainties and assumptions used in arriving at the amounts recognised in the accounts
- The level of detail and relevance of segmental disclosure, where management has significant discretion as to the method of analysis
- Whether non-accounting disclosures during the year have been consistent with the picture presented in the financial statements

3.1.3 Identification of 'red flags'

The information contained in the financial statements will be used for the analysis of the historical performance of a company or as the basis for the formation of expectations about the future performance of the company and the estimate of its value. The validity of all three tasks will depend on the reliability of the information derived from the financial statements. If the information is misleading then it may lead to erroneous conclusions about the past and future performance of a company. Thus the information contained in the financial statements should, as a first step, be assessed for its quality. There are three basic aspects that need to be taken into account when interpreting financial ratios, namely compliance of financial statements with IFRS, the quality of audit and the presence of creative accounting. Of the three, creative accounting is by far the main way of manipulating information and for this reason we devote more attention to it.

Creative accounting is the active manipulation of accounting results for the purpose of creating an altered impression of the underlying financial position or performance of an enterprise by using accounting rules and guidance in a spirit other than that which was intended when the rules were written.

The spectrum of creative accounting practices may include the following (commencing with the most legitimate):

- Exercise of normal accounting policy choice within the rules permitted by regulation (eg, first in, first out (FIFO) or average cost for inventory valuation)
- Exercise of a degree of estimation, judgement or prediction by a company within reasonable bounds (eg, non-current asset lives)
- Judgement concerning the nature or classification of a cost (eg, expensing or capitalising development costs)

- Systematic selection of legitimate policy choices and estimations to alter the perception of the position or performance of the business in a uniform direction
- Systematic selection of policy choices and estimations that fall on the margin of permitted regulation (or are not subject to regulation) in order to alter materially the perception of the performance or position of the business, for example the timing of revenues and receivables
- Setting up of artificial transactions to create circumstances where material accounting misrepresentation can take place
- Fraudulent activities

The following have been put forward as incentives for companies/managers engaging in creative accounting:

a. **Income smoothing**: Companies normally prefer to show a steady trend of growth in profits, rather than volatility with significant rises and falls. Income smoothing techniques (eg, declaring higher provisions or deferring income recognition in good years) contribute to reducing volatility in reported earnings.

b. **Achieving forecasts**: Where forecasts of future profits have been made, reported earnings may be manipulated to tie in with these forecasts.

c. **Profit enhancement**: This is where current year earnings are boosted to enhance the short-term perception of performance.

d. **Maintain or boost share price**: Where markets can be made to believe that increased earnings represents improved performance, then share price may rise, or at least be higher than it would be in the absence of creative accounting.

e. **Accounting-based contracts**: Where accounting-based contracts exist (eg, loan covenants, profit-related pay) then any accounting policy that falls within the terms of the contract may significantly impact on the consequences of that contract. For example, the breach of a gearing- based debt covenant may be avoided by the use of off balance sheet financing.

f. **Incentives for directors**: There may be personal incentives for directors to enhance profit in order to enhance their remuneration. Examples might include: bonuses based on earnings per share (EPS), share incentive schemes and share option schemes. Directors may also benefit more indirectly from creative accounting by increasing the security of their position. Incentives such as bonuses are not limited to incentives for directors and may be incentives for management who also have the ability to manipulate results on a day-to-day basis.

g. **Taxation**: Where accounting practices coincide with taxation regulations there may be an incentive to reduce profit in order to reduce taxation. In these circumstances, however, it may be necessary to convince not only the auditor, but also the tax authorities.

h. **Regulated industries**: Where an industry is currently, or potentially, regulated then there may be an incentive to engage in creative accounting to influence the decisions of the regulator. This may include utilities where regulators may curtail prices if it is perceived that excessive profits are being earned. It may also be relevant to avoid a reference to the Competition Commission.

i. **Internal accounting**: A company as a whole may have reason to move profits from division to division (or subsidiary to subsidiary) in order to affect tax calculations or justify the closure/expansion of a particular department.

j. **Losses**: Companies making losses may be under greater pressure to enhance reported performance.

k. **Commercial pressures**: Where companies have particular commercial pressures to enhance the perception of the company there is increased risk of creative accounting. For example, a takeover bid, and the raising of new finance.

Questionable accounting policies and inadequate disclosures may be regarded as warning signs that there are undue pressures on management to improve performance or that there is poor corporate governance. This might be reflected in both accounting policies and estimates adopted, but also by manipulation of underlying transactions that might be revealed by financial statement information, or hidden by inadequate disclosure.

'Red flags' and detection

The best detection techniques for creative accounting are a good knowledge of financial accounting regulation and a good understanding of the business. There may, however, be more general techniques and indicators that can suggest that a company is engaging in creative accounting practice. These include:

a. **Cash flows**: Operating cash flows are systematically out of line with reported profits over time.

b. **Reported income and taxable income**: Is financial reporting income significantly out of line with taxable income with inadequate explanation or disclosure?

c. **Acquisitions**: Where a significant number of acquisitions have taken place there is increased scope for many creative accounting practices.

d. **Financial statement trends**: Indicators include: unusual trends, comparing revenue and EPS growth, atypical year-end transactions, flipping between conservatism and aggressive accounting from year to year, level of provisions compared to profit indicating smoothing, EPS trend and timing of recognition of exceptional items.

e. **Ratios**: Ageing analyses revealing old inventories or receivables, declining gross profit margins but increased net profit margins, inventories/receivables increasing more than sales, gearing changes.

f. **Accounting policies**: Consider if there is the minimum disclosure required by regulation, changes in accounting policies, examine areas of judgement and discretion. Consider risk areas of: off balance sheet financing, revenue recognition, capitalisation of expenses and significant accounting estimates.

g. **Changes of accounting policies and estimates**: Is the nature, effect and purpose of these changes adequately explained and disclosed?

h. **Management**: Estimations proved unreliable in the past, minimal explanations provided.

i. **Actual and estimated results**: Culture of always satisfying external earnings forecasts, absence of profit warnings, inadequate or late profit warnings leading to 'surprises', interim financial statements out of line with year-end financial statements.

j. **Incentives**: Management rewarded on reported earnings, profit-orientated culture exists, other reporting pressures eg, a takeover.

k. **Audit qualifications**: Are they unexpected and are any auditors' adjustments specified in the audit report significant?

l. **Related party transactions**: Are these material and how far are the directors affected?

The above is not a comprehensive list, but merely includes some main factors. Also, it is not suggested that the above practices necessarily mean there is creative accounting but, where a number of these factors exist simultaneously, further investigations may be warranted. Any review of such 'red flags' as warning signs needs to be seen within the bigger picture of the current commercial situation of the company, and the strategy it is adopting.

3.1.4 Elimination of accounting distortions and restatement

The final step of the accounting analysis is the elimination of the distortions from the financial statements and their restatement with the correct information. We shall devote a whole section to this topic later.

Professional skills focus: Assimilating and using information

Note the importance of using the data analytics software to bridge the gap between financial reporting and auditing. The data analytics software can be used to identify risky transactions for additional testing, for example unusual transactions or trends.

3.2 Sources and problems of accounting information

Accounting information is contained in the financial statements of a firm, namely:

- the statement of financial position;
- the statement of profit or loss and other comprehensive income or separate statement of profit or loss and separate statement of comprehensive income disclosing other comprehensive income;
- the statement of changes in equity; and
- the statement of cash flows.

These are in addition to the notes to the financial statements and market values or prices.

Unfortunately, the accounting information contained in the above sources can be manipulated by the management of a company, for a variety of reasons. For even when a company follows closely the accounting standards, there may be some discretion afforded in the presentation of the accounts.

That is why the first two aspects of the financial analysis process, as defined in the previous section, deal with the assessment and correcting of financial information.

Every financial statement produced by a corporate entity should be produced according to some accounting standard. All EU member states, and many other countries outside the EU, have adopted the International Financial Reporting Standards (IFRS® Standards) for listed companies. The adoption of common accounting standards restricts the freedom of management to record the same transaction in different ways. The uniformity of accounting standards makes comparison between firms and across time easier. However, this comes at the expense of flexibility in the accounting treatment of genuinely different businesses.

One example where such a rigidity and lack of management discretion may lead to distortion of accounting figures is IAS 38, *Intangible Assets* which requires firms to recognise assets for development expenditure when they are likely to produce future economic benefits, but also requires firms to expense the preceding research outlays when they are incurred. Development expenditures are those incurred for the actual development of a new product. Research expenditures on the other hand are not directly associated with any product, although some research expenditure will give rise to a future product. IAS 38 does not allow firms to distinguish between research and development expenditure in the early stages leading to a systematic distortion of reported results.

The IASB has tried to reconcile consistency with rigidity and in many cases the standards define general principles rather than specific rules. However, the direction of travel in some of the recent standards is towards clear guidance. A good example of this approach is IFRS 16 on leasing, which gives the directors little discretion at the margin to decide which arrangements constitute a lease.

Another source of potential distortion of accounting information is the requirement that management predict the future outcome of current transactions. When a firm makes a sale on credit, accrual accounting principles require that managers estimate the probability of collecting the future payments from the customer. If the probability is high the transaction is treated as a sale creating trade receivables on its statement of financial position. Managers then have to make an estimate of the receivables that will be collected, which may differ from the realised payments.

The broad-based approach of the IASB which affords a certain degree of discretion to the management of a company, and the nature of accrual accounting imposes an additional burden of interpretation and judgement on the auditor and the user of the financial information.

3.3 Audit and financial statement quality

The first verification of the integrity of any financial statements produced by a company is performed by the external independent auditors of the company.

Although auditing presents an independent assessment of the firm's financial statements, auditing is not sufficient to prevent fraudulent presentation of the financial health of a company by management which, as the cases of Enron and Parmalat show, might not be detected by the auditors.

These failures of the auditing processes may be due to inadequate adherence to auditing rules, lack of understanding of the business, or simply connivance on the part of the auditing team. Given these auditing failures, the audited accounts of a company should not be accepted uncritically as the basis for drawing conclusions on a company's historical or predicted performance.

In the following section we look at some of the areas of the financial statements and the accounting policies that may give rise to distortions of the financial information.

4 Accounting distortions

Section overview

This section discusses the most common distortions in the accounting information contained in the financial statements.

In the previous section we discussed the potential for distortion of accounting information. In this section we discuss the most common distortions and how these may arise.

4.1 Distortions in assets

Distortion in assets takes the form of overstating assets which is reflected in increased reported earnings (increased revenue or reduced expenses) or understating assets which is reflected in deflated earnings (reduced revenue or increased expenses).

The main reason for the distortion of assets is due to the ambiguity or the freedom of accounting reporting rules. We look at some of the most salient examples of the international accounting standards and how they can give rise to this kind of distortion.

Asset distortion can be the result of earnings smoothing where earnings are overstated or understated so as to eliminate volatility and present a smooth pattern over time.

4.1.1 Depreciation and amortisation of non-current assets

The using over time of non-current assets must be recorded in profit or loss. The depreciation of a non-current asset should match the decline in its remaining economic life, which needs to be estimated. The salvage value of the asset at the end of its economic life also needs to be estimated. Thus the depreciation expenditure recognised in profit or loss is partly at the discretion of the management. Two different companies operating in the same industry may end up with different depreciation schedules because of the different assumptions on economic life and residual values. Lufthansa for example assumes a shorter economic life for its aeroplanes than British Airways but the interpretation of this accounting policy difference may be unclear.

Context example: British Airways and Lufthansa

The German airline Lufthansa reported in its financial statements that it depreciates its aircraft over 12 years on a straight-line basis using an estimated residual value of 15% of the original cost.

By contrast, British Airways reported in its financial statements that it depreciates its aircraft over 20 years on a straight-line basis using an estimated residual value of 8% of the original cost.

The difference could lie as much in the companies' asset replacement policies as in their depreciation policies.

The difference might be one of mere accounting policy choice where financial analysis would need to make adjustments to compare like with like when interpreting the underlying performance of the two companies. Alternatively, there may be differences of commercial substance that would make a different depreciation policy acceptable as reflecting commercial reality, in which case no adjustment would be needed.

Possible commercial explanations to justify the different depreciation treatment would be: different utilisation of aircraft, different types of aircraft being used, different maximum speeds, more long- or short-haul flights, different levels of maintenance and use of older planes.

In fact, any difference is likely to be a mix of accounting and commercial differences and any analysis needs to exercise careful judgement in making relevant adjustments. An understanding of management motivations may also help. In the case of Lufthansa the depreciation rates were used for tax purposes whereas this was not the case with British Airways.
(Source: Palepu, K.G., Healy, P.M., Bernard, V.L., Peek, E. (2007) Business & Economics. London: Thomson Learning)

4.1.2 Capitalisation of development costs and intangible assets

The growth of internet, telecommunications and service companies has made the measurement of intangibles a key issue, even though it is difficult to measure precisely their value. With financial statements treating many intangibles as off-balance sheet assets, there may be little information to make such valuations within the financial statements.

In many traditional industries such as the pharmaceutical industry where research and development expenditure plays an important role, the non-recognition of research and development as capital due to the uncertainty of future benefits may lead to valuable assets being ignored or overlooked.

The impact of ignoring intangible assets or not valuing them properly on all ratios that involve the use of asset estimates can be significant. Profitability ratios such as the return on assets or activity ratios will be overstated, making it difficult to analyse historical performance, to forecast performance or to value a company.

4.1.3 Leased assets

Until recently, the main issue regarding leased assets was whether lease payments should be recognised as capital costs and hence capitalised and depreciated, or whether lease payments should be treated as an expense. In the first case the lease was a finance lease, whereas in the second case it was an operating lease. Despite strict classification criteria, there was still scope for discretion on the part of management leading to an understatement of assets classified as held under finance leases and therefore of the total assets of the company.

The introduction of IFRS 16, *Leases* (covered in earlier Chapters) will make such distortions much more difficult to achieve. IFRS 16, which is effective for periods beginning on or after 1 January 2019, requires that lessees recognise all leases in the statement of financial position except for short leases and leases of low-value assets. For lessors the distinction between finance and operating leases still applies.

Now that the option of operating leases is no longer available for lessees, entities wishing to avoid capitalising lease payments may attempt to demonstrate that the transaction is not a lease. IFRS 16 contains many examples that demonstrate clearly whether a transaction is or is not a lease, covered in detail in earlier Chapters, and this could form the basis of part of a question, possibly in the context of ethics.

This will affect the gearing ratio where leases are treated as part of long-term debt. Research shows that putting leases in the statement of financial position has significant effects on gearing and other key ratios.

4.1.4 Sale and leaseback transactions

Some companies use sale and leaseback transactions as a means of raising finance. This is a common feature of certain industries such as retailing and hotels where the entity may have a significant number of high value properties.

Before IFRS 16 (see above), where a sale and leaseback transaction resulted in an operating lease and the transaction is established at fair value, any profit or loss was recognised immediately.

However, this treatment is no longer available under IFRS 16. Under IFRS 16, only the gain that relates to the rights transferred may be recognised. In addition, such transactions must meet the criteria under IFRS 15, *Revenue from Contracts with Customers* to be recognised as a sale, based on the satisfaction of IFRS 15 requirements on performance obligations. Should the transaction not meet these criteria, the entity must continue to recognise the asset 'sold' and a financial liability equal to the 'sale' proceeds by applying IFRS 9. Fewer transactions are likely to qualify than formerly, so there will be less incentive to undertake such an arrangement.

Context example: Shipping industry

On 4 July 2019, Moore Stephens published an online report *Sale and Leaseback Transactions and IFRS 16 Implications,* which discusses the effect of IFRS 16 in the context of the shipping industry:

"The implementation of the new standard may have a substantial impact on gearing ratios of shipping companies that charter in a substantial number of vessels under an operating lease, as the new treatment will increase both gross assets and liabilities. Total debt will be higher and this may have an impact with loan covenants based on total debt levels as it may lead to breaches due to the upcoming accounting changes.

The changes could also impact profitability. Under the current treatment, costs are spread evenly over the period of the operating lease. Under the new standard, there are two elements determinant:
1) the depreciation of the vessel; and 2) the interest charge. The depreciation will be accounted for using the straight line method but the interest charge will be weighted towards the earlier part of the lease. Although the total lease charge will be the same over the charter period, it will be more front- loaded, with higher charges in the earlier years and lower charges in the later years."

(Drakoulakos, 2016)

4.1.5 Mergers and acquisitions

Accounting for mergers and acquisitions follows two approaches: the pooling of interests method (merger accounting) and the acquisition method (acquisition accounting).

Under the acquisition method, the cost of merger for the acquiring firm is the actual value that was paid for the acquisition of the target company's shares. If the price paid plus the value of the non- controlling interest is above the value of the acquiree's net assets, then the excess is recorded as goodwill on the acquiring firm's statement of financial position.

While the pooling of interests method is not permitted by IFRS 3, *Business Combinations*, there is no requirement for retrospective adjustment of previous mergers. This creates problems when financial ratios are used for the evaluation of the historical performance of a company. To standardise the method of consolidation, the pooling of interests needs to be reversed and replaced by the acquisition method, which requires fair value adjustments and recognition of goodwill.

4.1.6 Revenue recognition

Managers sometimes have incentives to recognise future revenues overstating earnings and receivables. This will, of course, be followed by a decline in the earnings in subsequent years, so unless a company experiences a consistent growth in earnings, early revenue recognition will not help the long-term performance of the company. IFRS 15, *Revenue from Contracts with Customers,* in force since January 2018, is much more specific than its predecessor about the amount and timing of recognition.

4.1.7 Allowances

Management may sometimes find it to its advantage to underestimate the expected default loss from receivables and thus to underestimate allowances and overstate earnings and assets.

4.1.8 Discounted receivables

Companies may sell their receivables in order to boost their liquidity. There are two options for the recording of such a sale. The first is for the transaction to be recorded as a sale. The second is for the transaction to be recorded as a loan with the receivables being collateral. Such a transaction will be recorded as a sale if the IFRS 9, *Financial Instruments* criteria for derecognition are met and the buyer undertakes all the risks and rewards of the receivables.

4.2 Distortions in liabilities

The most common distortion on the liability side involves:

- provisions
- unearned revenues
- post-employment benefit obligations

4.2.1 Provisions

A firm that expects a future outflow of cash due to a contractual obligation but whose exact amount is not known will need to make a provision for such a liability. Firms, however, have the discretion to estimate these future liabilities and the possibility to understate them on their statement of financial position.

4.2.2 Unearned revenues

Unearned revenues arise when a company receives payments in advance of selling the good or service. Such unearned revenues create liabilities that need to be recognised. Companies may understate such a liability.

4.2.3 Post-employment benefit obligations

Under IFRS Standards, firms that provide pension benefits or other post-employment benefits to their employees need to recognise the present value of future payments net of the assets that are dedicated to the payment of these future benefits. The company needs to adjust these liabilities every year in the light of current service costs, interest costs, actuarial gains and losses, past service costs and benefits paid.

4.3 Distortions in equity

Distortions in equity arise either from contingent claims or the recycling of gains and losses (reclassification from equity to profit or loss). Contingent claims take the form of stock options or conversion options.

Stock options

Stock options give the right to employees to buy a company's shares at a predetermined price within a specific period of time. IFRS 2, *Share-based Payment* requires that firms should report the cost of options as an expense in profit or loss using the fair value of the option, which can be estimated using option valuation models. However, such models are not very accurate, as they depend on the volatility of share prices which is not observable and has to be estimated from market data. Thus it is possible that the cost of stock options may not be stated correctly.

Conversion options

Convertible bonds can be considered as being made up of an ordinary bond and a call option on the shares of the company. IFRS 9 requires that the company values the ordinary bond component separately from the call option component.

Reclassification (recycling) of gains and losses

Gains or losses on some items may be recorded as other comprehensive income and accumulated in equity, and later reclassified to profit or loss. Gains or losses on other items may not be reclassified to profit or loss. (IAS 1, *Presentation of Financial Statements* now distinguishes between these two types of gains/losses.)

5 Improving the quality of financial information

Section overview

This section suggests ways of undoing the accounting distortions in the financial statements, and produces a measure of sustainable earnings. The possibility of using cash flow data instead of earnings is also discussed.

5.1 Undoing accounting distortions

If financial analysis reveals that a company's financial statements are deemed to be inadequate, misleading or atypical of the industry, then it is important that adjustments are made to undo the inadequate policies, as far as possible, in order to produce 'standardised' accounts which can form the basis for decision-making, forecasting future performance on a comparable and valid basis and, ultimately, contribute to an appropriate valuation.

It should be noted that accounting manipulation and 'red flags' could arise not only where management are attempting to inflate profit. Overconservative accounting, or excessive prudence, may be as much of an issue as aggressive earnings management when attempting to forecast future earnings from a current earnings basis.

Key information as a starting point to make such adjustments is disclosed in the notes to the financial statements, and the statement of cash flows. Other information in the public domain about the company should also be used.

The following sections give examples of specific adjustments that can be made to the statement of financial position and the statement of profit or loss (and other comprehensive income) as part of the process of standardisation.

5.2 Statement of financial position adjustments

The statement of financial position shows the assets, liabilities and equity of a company. The two major issues arising from accounting policies, even when they are in full compliance with IFRS, are:

- the amounts at which assets and liabilities are measured may differ significantly from their economic values; and
- some valuable assets and significant liabilities may not be recognised at all.

Any forecast based on accounting information which is to be used for cross-sectional comparison purposes, or as an input into a valuation model, first needs to address these issues by making appropriate adjustments by:

- remeasuring assets and liabilities at fair market values;
- adding back (ie, recognising) off balance sheet liabilities and assets with commercial value; and
- adding back assets that have been previously written off (goodwill, impairment reviews etc).

In practice, most acquirers and investors determine firm value by calculating the sum of the market value of the debt and the equity invested in the business. In this case, a separate valuation of individual operational assets and liabilities rarely takes place. A large proportion of firm value is likely to be related to the present value of future growth opportunities, and is not represented by current earnings or assets.

In contrast, lenders calculate firm value from the worst-case perspective. They often estimate the fair value of assets in place assuming a break-up, to check that the capital of their loan is secure.

5.3 Adjusting the assets

If the carrying amount (ie, 'book value') of assets is either understated, or overstated, by comparison with their economic values and with those of comparable companies, this can have important implications for forecasting and valuation. As an example, some companies may wish to state assets at cost rather than a revalued amount as, although revaluation 'improves' the statement of financial position, it does so at the cost of higher depreciation and lower reported profit. This may affect some companies (eg, those with profit-related remuneration schemes or with earnings-based covenants) more than others. Some examples and motivations were discussed in the previous section.

Non-current assets

There are a number of areas that affect the recognition and recording of non-current assets, such as fair value recognition, depreciation and amortisation, inflation, impairment and interest capitalisation. In order to adjust the financial statements, financial analysis will be required to do the following:

(a) Revalue to fair value non-current assets which are currently recognised in accordance with the cost model and/or assets which have not been revalued recently

(b) Standardise the depreciation method

(c) Review asset lives compared with competitors and recent replacement policy (eg, consider profit/loss on disposal, readjustments of asset lives). See the 'British Airways and Lufthansa' illustrative example above

(d) Review residual values (eg, a weakness in the market for secondhand aircraft caused a significant depreciation adjustment by EasyJet in 2004)

(e) Impact of foreign currency – for non-monetary assets no adjustments are made under IAS 21, *The Effects of Changes in Foreign Exchange Rates* for exchange rate movements after purchase (although there will be an impact of foreign currency changes over time if there are consistent asset replacements)

(f) Look for evidence of adequacy of impairment charges (eg, poor trading conditions, decline in fair values, previous recent revaluations, rival companies' recognition of impairment in similar assets)

(g) Impact of general inflation or sector inflation

(h) Capitalisation of interest policy to be standardised with comparable companies, normally by treating the interest as an expense and deducting it from the asset value

Intangible assets

There are two general approaches to resolving the problems generated with the accounting treatment of intangibles. The first approach is to leave the accounting numbers as they are, but in analysing historical performance and in forecasting the analyst should be aware that the rate of return is understated and that it represents the lower end of the estimates. The second approach involves recognition of the intangible asset and amortisation over their expected life.

(a) Revalue at fair value intangible assets which are currently recognised in accordance with the cost model, or that have not been revalued recently. This process may be very difficult in some circumstances, and could amount to valuing the company as a whole. However, if the purpose of adjustments is to forecast firm values, then the process becomes circular.

(b) Recognise internally generated intangible assets at fair value where IAS 38 and other asset recognition criteria are not satisfied, but the assets have commercial value. (For many 'asset-light' companies the statement of financial position would be largely meaningless unless unrecognised intangibles are reinstated at some estimated value.)

(c) Consider capitalisation of the commercial value of unrecognised R&D costs, particularly where these are significant, and a key factor for success such as in the pharmaceuticals industry.

(d) Review the amortisation policy for intangible assets for consistency and comparability, in terms of both asset life and residual value.

(e) Look for evidence of adequacy of impairment charges.

(f) Consider changes in the fair value of goodwill on acquisitions.

Leased assets

Whether an arrangement constitutes a lease or not affects the statement of financial position and the profit or loss and hence a large number of key ratios. IFRS 16, *Leases* makes it very clear whether or not an arrangement is a lease and requires recognition of all leases (except short leases and leases of low-value items) in the lessee's statement of financial position. But even if the standard's strict criteria have been applied, it may be sensible to do the following:

- Consider, and if necessary recompute, the method of allocating finance charges on leases over the period of the lease, in particular having regard to whether the interest rate implicit in the lease has been used correctly (or, if this is not available, the lessee's incremental borrowing rate).
- Review depreciation policy and asset lives as for owned assets.

Inventories

(a) Standardise for the effects of different inventory identification policy choices, including FIFO, average cost and standard cost.

(b) Consider specific price changes in the industry.

(c) Consider adequacy of write-downs to net realisable value, particularly where inventory volumes have increased, or where prices have fallen.

(d) To the extent of available disclosure, consider the impact of overheads being included in inventories on a reasonable basis, particularly where inventory volumes have changed in the year.

(e) Impact of foreign currency – as inventories are a non-monetary asset, no adjustments are made under IAS 21 for exchange rate movements after purchase (although there will be an impact of foreign currency changes over time as there are consistent inventory replacements).

Receivables

(a) Consider adequacy of bad debt write-offs (eg, compared with competitors, prior experience, known insolvencies among customer base, increases in receivables days ratio).

(b) Consider the likely timing of any bad debt recovery, and how it might affect liquidity.

(c) Consider impact if any factoring has taken place.

Long-term assets

- If stated at fair value, consider valuation method used if disclosed, and any post year end changes.
- Review companies on the border of control and significant influence. Equity accounting would take only net assets into consideration, and would take an associate's liabilities off the consolidated statement of financial position. The restatement of an associate on a full consolidation basis may be appropriate where significant influence borders on *de facto* control. This may significantly affect reported consolidated figures for highly geared associates. The information would be available to the analyst on the basis of the disclosure in the financial statements of the individual companies.

5.4 Adjusting liabilities

The main adjustments to liabilities are:

Long-term debt

The liability may not reflect its fair value if stated at amortised cost. The appropriate adjustment is to review the value of the liability eg, where interest rates or the credit rating of the company have changed.

Also financial instruments containing equity and debt elements, such as convertibles, would need to be reviewed for likelihood of conversion, and any changes in the fair value of the instruments since issue.

Deferred tax

(a) Here we should consider how much, if any, of the provision is likely to crystallise and thus create a future cash outflow. All will reverse on individual assets. However, we must consider the different reversal horizons (eg, there may collectively be no reversals if there is a constantly expanding pool of non-current assets).

(b) Estimate the effects of likely changes in future tax rates which have not been recognised.

(c) Discount future cash flows arising from reversals, and calculate the present value benefit of paying tax later.

(d) Assess recoverability of deferred tax assets (eg, on losses).

Employee benefits

(a) The present value of future obligations can be very sensitive to the assumptions made. Adjustments to the value of the obligation may be required if the assumptions are considered unreasonable.

IAS 19 requires that the assets and liabilities are valued using the rate applicable to 'high-quality corporate bonds'. This has the effect of automatically overstating the present value of liabilities in pension funds.

(b) Stock options under IFRS 2 only reflect the market value at the granting date. The future value sacrifice from strongly in the money employee options may therefore be far greater than is reflected in the financial statements if share prices have risen since the options were granted.

In contrast, gains arising from pension scheme curtailments should result in immediate recognition in profit or loss and a reduction in the present value of the defined benefit obligation.

Context example: British Airways

UK airline British Airways recognised a credit of £396 million in its income statement for the year ended 31.3.07, with respect to changes in a pension scheme. The recognition of £396 million represents 65% of pre-tax profit.

The changes made to the pension scheme included a restriction in future pension increases to movements in the Retail Price Index and an increase in the retirement age to 65.

British Airways plc

Year end	**31.3.07**	**31.3.06**
	£m	**£m**
Turnover	8,495	8,515
Profit before tax	611	620

(Source: British Airways (2008) *Group consolidated income statement*. [Online]. Available from: https://www.britishairways.com/cms/global/microsites/ba_reports/fin_statements/fs_income.html [Accessed 1 October 2021])

Provisions

Assess probability of provision crystallising, and consider including expected values based on probabilities.

Contingent liabilities

Consider recognition on the basis of expected values based on possibility of occurrence of certain events.

5.5 Adjustments in the statement of profit or loss (and other comprehensive income)

In the same way that reported statement of financial position items need to be restated into a standardised format that reflects their fair value, income and expense items need to be adjusted on a similar basis to improve the quality of earnings. The main adjustments needed are as follows:

(a) The removal of 'non-operating items' from reported income, in order to provide a better measure of operating earnings that are driven by sales to make more valid like for like inter- period comparisons, and to highlight sales margins on a consistent basis.

(b) The removal of non-recurring elements of operating earnings, in order to gain a measure of sustainable earnings. This provides better profit forecasts and improved valuations. The most common non-recurring elements are:

- exceptional items
- discontinued operations
- acquisitions
- elements recognised as other operating income

(c) The adjustment of costs and revenues to a fair value basis, so that they better reflect the fair value of resources consumed and earned in the period. Frequently, this is the other side of the coin to the statement of financial position adjustments highlighted above, but this can also involve correcting for aggressive earnings management.

The above distinctions are not always clear, and different judgements may be formed as to what 'normal' earnings are, and what might be termed 'noise'. Moreover, even where there is agreement as to a transaction having a non-recurring element, there is not always sufficient disclosed information in order to make adjustments with any precision. In such cases, estimates would need to be made on the basis of Keynes's dictum that it is better to be roughly right, than precisely wrong!

It might be worth noting, however, that in normal operating contexts, historical cost measures have been shown by empirical evidence to be both good predictors of current performance and significant valuation tools.

Exceptional items

As exceptional items would not normally recur, they would not form part of future earnings, and thus should be removed. However, while any one type is unusual, exceptional items are generally very common, and are likely to recur in some form in years to come. Indeed, it might be said that the only exceptional thing about such costs is that it is extraordinary for companies not to have them. Care, therefore, needs to be exercised in judging whether an item disclosed separately is, in fact, unlikely to recur.

It is also important not always to accept the judgement of management as to what is exceptional and what is part of normal recurring activities. One view is that exceptional costs are more likely to be separately disclosed by management than exceptional income.

IAS 1, *Presentation of Financial Statements* requires that, where items of income or expenditure are material, their nature and amount should be disclosed separately. These are sometimes called 'exceptional items', although IAS 1 does not use that phrase. The following list illustrates some such items:

- Write-downs of inventories or of non-current assets
- Reversals of previous asset write-downs
- Restructuring costs and provisions
- Disposal of major non-current assets
- Disposals of major investments
- Litigation settlements
- Foreign currency exchange losses or gains
- Government grants
- Significant changes in the fair values of investment properties

Presentation requirements are that the items must:

- appear as a separate line item;
- be presented 'above the line' (ie, as part of pre-tax profit); and
- be presented as part of continuing activities (unless specifically covered by IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*).

IAS 1 expressly forbids the presentation of 'extraordinary items' (ie, items presented 'below the line').

In 2013, Standard & Poor produced a report titled *How Exceptional Accounting Items Can Create Misleading Earnings Metrics,* in which the author Sam C Holland argues:

"The separation of exceptional or special items that companies consider are one-off or non-recurring in nature can lead financial statement users to focus on companies' subjective, adjusted profit measures, rather than on the unadjusted figures that the International Accounting Standards Board (IASB) mandates companies to disclose.

[…]

The reported amount of revenues and other income items of profit-making companies exceeds the reported amount of debits or costs. Therefore there is no prima facie reason why one would expect exceptional costs to have a higher reported value than exceptional credit items. However, in order to show the adjusted operating performance in the most flattering light, companies may identify the exceptional items that hindered business performance rather than those that helped."

Operating Profit For Sample Of 10 Non financial FTSE 100 Companies

Company	No. of years where adjusted Description of adjusted operating profit is more than operating profit measure IFRS operating profit		Restructuring costs or impairments in at least three of four years
Bristish American Tobacco PLC	Adjusted profit from Operations	4	Yes
Smiths Group PLC	Headline operating profit	3	Yes
Unilever PLC	Underlying operating profit 3		Yes
Whitbread PLC	Underlying operating profit 3		Yes
Shire Pharmaceuticals Group PLC*	Non GAAP operating Income	4	Yes
GKN Holdings PLC	Trading profit	3	Yes
BG Group PLC	Business Performance	3	Yes
Associated British Foods PLC	Adjusted operating profit	4	No
The Sage Group PLC	Non GAAP EBITDA	4	No
Serco Group PLC	Adjusted operating profit	4	No

*Shire reports under U.S GAAP

The report argues that these companies' adjusted operating profits often exclude costs related to restructuring, for example impairment of goodwill, that are in fact recurring.

Discontinued operations

A discontinued operation is a component of a company which, according to IFRS 5:

- Has been disposed of in the current period; or
- Is classified as held-for-sale, where there would normally be a co-ordinated plan for disposal in the following period

The component might, for example, be a major line of business, operations in a particular geographical area, or a subsidiary.

The profit or loss after tax from discontinued operations is disclosed as a single figure on the face of the statement of profit or loss and other comprehensive income or statement of profit or loss. An analysis should be disclosed (normally in the notes to the financial statements) to show the revenue, expenses, pre-tax profit or loss, related income tax expense, and the profit or loss on asset disposals.

These items will not form part of sustainable future earnings, and should be removed when forecasting future performance.

In addition, for a discontinued operation, the company should disclose the net cash flows attributable to the operating, investing and financing activities of that operation.

Acquisitions

Where a company has made an acquisition of a subsidiary, or an associate, during the period, only the post-acquisition profit or loss will have been included in the consolidated statement of profit or loss (and other comprehensive income) of the period. In determining sustainable profit, consideration needs to be given to the fact that in subsequent years a full year's profit or loss will be consolidated and, therefore, a time adjustment will need to be made.

However, a series of other factors will also need to be considered, including:

- restructuring costs;
- profit or loss on sale of redundant assets;
- new transfer pricing arrangements;
- other costs of integration;
- changes in accounting policies to make subsidiary consistent with group policies; and
- change in accounting year end to make subsidiary coterminous with the group.

Some of these items will be disclosed, but in other cases analysts would need to make a 'best guess' on the basis of any information that is available.

Elements recognised as other comprehensive income

IAS 1 requires certain items to be recorded as other comprehensive income and accumulated in equity. These are as follows:

- Revaluations of tangible and intangible non-current assets (IAS 16, *Property, Plant and Equipment* and IAS 38)
- Particular gains and losses arising on translating the financial statements of a foreign operation (IAS 21)
- Gains and losses on remeasuring investments in equity instruments, where an irrevocable election has been made to do so (IFRS 9)
- Gains and losses on cash flow hedges (IFRS 9)
- Tax (including deferred tax) on items recognised as other comprehensive income (IAS 12, *Income Taxes*)

In addition, certain items are recognised directly in reserves and disclosed in the statement of changes in equity. These are as follows:

- Equity dividends (IAS 1)
- The correction of errors from prior periods (IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*)
- The effects of changes in accounting policies (IAS 8)

While some of these items might reasonably be expected to recur, they are likely to do so in a random and uncertain manner, with varying effects. Overall, therefore, their non-predictability needs to be considered in evaluating future performance based on current period financial reporting. Note that these items will not affect EPS and reporting earnings directly, but they do form part of a wider measure of comprehensive income achieved by a company.

Accounting estimates

The preparation of financial statements requires many estimates to be made on the basis of the latest available, reliable information.

Key areas in which estimates are made include the following:

- The recoverability of amounts owed by customers
- The obsolescence of inventories
- The useful lives of non-current assets
- The values of non-current assets

As more up to date information becomes available, estimates should be revisited to reflect this new information. These are changes in estimates and are not changes in accounting policies or the correction of errors.

Changes in estimates are recognised in the period in which the change arises. The effect of a change in an accounting estimate is, therefore, recognised prospectively, ie, by recognising the change in accounting estimate in current and future periods affected by the change. As a consequence, such items should not normally result in large one-time charges, but may cause a reassessment of management's ability and willingness to make reasonable estimates elsewhere in the financial statements.

Prior period errors

A prior period error is an error that has occurred even though reliable information was available. Examples of such errors are:

- mathematical errors
- mistakes in applying an accounting policy
- oversights, or misinterpretation, of facts
- fraud

It should be noted that auditing standards clearly distinguish between fraud and errors, in that fraud is intentional and errors are not. It is normally important to distinguish between misstatements, errors and frauds, but the retrospective accounting treatment is the same in this instance in accordance with IAS 8.

As such, errors may relate to a number of reported periods. IAS 8 requires that these errors are to be adjusted in those past periods rather than in the current period. They will not, therefore, affect current earnings, but may cause doubt about the efficiency of internal controls and raise the possibility that other similar undisclosed errors may have been made.

Re-estimating costs and revenues to fair values

It is necessary to adjust costs and revenues to a fair value basis, so that they better reflect the fair value of resources consumed and earned in the period. This might include making adjustments that correspond to those for the statement of financial position, but also correcting for aggressive earnings management.

Examples of this type of adjustment might include the following:

- Adjustment of historical cost depreciation to a fair value basis
- Adjustment of historical cost amortisation of intangibles to a fair value basis

- Expensing of capitalised interest
- Adjustment for the impact of share-based payments, such as stock options, to the extent that they do not reflect fair value changes since issue (as required by IFRS 2)
- Consideration of how much, if any, of the provision for deferred tax charged in the period is actually likely to reverse, and thus create a future cash outflow
- Adjustment for revenue recognition if there is evidence of aggressive earnings management through accounting policies and estimates, or through unduly advancing actual transactions

5.6 Normalising earnings

Both basic and diluted earnings can be manipulated by the management of a company directly or indirectly. In order to render the earnings figure into a meaningful piece of information the earnings figure needs to be adjusted to reflect the true potential and sustainable earnings of a company. The end result of the standardisation process is a normalised/sustainable earnings schedule which not only adjusts for the differences in recognition and measurement, but also provides a template for standardising presentation, terminology and categorisation.

The following table represents a pro forma, although this is likely to vary with differences between analysts and between the reporting regimes under which the companies being analysed operate.

	£'000	£'000
Sustainable operating income		
Sustainable revenue		X
Sustainable cost of sales		(X)
Sustainable gross profit		X
Sustainable operating expenses		(X)
Sustainable operating profit before tax		XX
Income tax as reported	(X)	
Tax benefit from finance costs	X	
Tax on exceptional items	X	
Tax on other sustainable operating income	X	
Element of deferred tax charge unlikely to crystallise	X/(X)	
Tax on sustainable operating profit		(X)
Sustainable operating profit from sales		XX
Sustainable other operating income	X	
Tax on sustainable other operating income	(X)	
Sustainable other operating income after tax		X
Sustainable operating profit after tax		XX
Non-recurring and unusual items		
Profit from discontinued operations	X	
Changes in estimates	X/(X)	
Profit/losses on sale of non-current assets	X/(X)	
Impairment charges	X/(X)	
Start-up costs expensed	(X)	

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	£'000	£'000
Restructuring costs expensed	(X)	
Redundancy costs	(X)	
Unusual provisions	(X)	
Changes in fair values	X/(X)	
Foreign currency gains/(losses)	X/(X)	
Other unusual charges and credits	X/(X)	
Tax on unusual items	(X)	
Non-recurring and unusual items after tax		XX
Profit for the period before finance charges		XX

Note: The above items are stated after standardisation adjustments to individual costs and revenues.

5.7 Statement of profit or loss (and other comprehensive income) adjustments for comparison

The items adjusted above are primarily concerned with determining a comparable trend in operating earnings over time for one company. A key part of financial analysis is also comparing the performance of companies in the same industry.

Such a process will involve normalising accounting policies and estimates across companies as well as over time. As the above illustrative example on British Airways and Lufthansa illustrates, however, this does not mean merely applying the same policy mindlessly to all companies irrespective of circumstances. It may be that different policies and estimates are appropriate to the different economic circumstances of different companies.

A particular difficulty of comparisons arises internationally, where two companies report under different GAAP. For instance, it might be necessary to compare one company reporting under US GAAP with another reporting under IFRS. In these circumstances, there are differences not only in accounting policy selection within a given set of GAAP, but also between the two sets of GAAP. Further adjustments have to be made but any comparisons may be weakened.

Items adjusted as part of pre-tax profit under any of the above headings will also require estimates to be made of the taxation effects, including deferred tax. In so doing, the marginal rate of tax will need to be used where this differs from the average rate.

5.8 Cash flow alternatives to earnings

One solution to the quality of earnings problems sometimes put forward is to examine cash flows instead – the 'cash is king' view. It may be argued that operating cash flows are at least hard figures which are independent of judgement and accounting manipulation. In particular, it may seem as though operating cash flows are recurring and sustainable. Such a view would be inappropriate in many circumstances.

Depreciation and free cash flow

First, operating cash flow adds back depreciation as an accounting number that does not involve a movement of cash. Further down the statement of cash flows, however, there is likely to be a significant outflow under investment activities on the acquisition of non-current assets. Such expenditure, to sustain the asset base of the business, should be regarded as part of recurring cash outflows, as without it the business would decline. Thus, while an arbitrary depreciation figure is excluded, a figure of cash outflows on non-current assets which is under the discretion of management replaces it. R&D expenditures would be a particular example of an item where there is significant management discretion over cash flow expenditure.

Timing of payments

Management may have significant discretion over the timing of some types of payment. In the period leading up to the reporting date, cash payments can be delayed to reduce cash outflows on operations, and increase cash balances. Arguably, there is more discretion on the timing of payments in the statement of cash flows than there is over the timing of the transactions themselves in the statement of profit or loss and other comprehensive income.

Unusual items

Exceptional items are normally included in operating profit. They need to be distinguished from recurring items in cash terms in the statement of cash flows, as well as in accruals terms in the statement of profit or loss and other comprehensive income.

Smoothing and the long term

Some costs are recognised in profit or loss, but will not be cash transactions for some time into the future, and thus would not appear in the current year's statement of cash flows. Examples would include provisions under IAS 37 where the statement of profit or loss and other comprehensive income recognises a future cash flow in the current period as an early warning signal. It is only identified in the statement of cash flows at a much later stage.

A more extreme example is decommissioning costs which are a cash flow, perhaps a long time into the future, but are recognised in present value terms in the statement of profit or loss and other comprehensive income as each year passes.

In both these examples, the statement of profit or loss and other comprehensive income provides a better guide to future forecast cash flows than the historical statement of cash flows.

Non-cash costs

Some costs are recognised in the statement of profit or loss and other comprehensive income but will never be recognised in the statement of cash flows. Share-based payments under IFRS 2 involve an annualised cost of share-based payments, such as employee share options. Such a cost may be inaccurate, being based on the market value at the grant date, but the statement of cash flows does not recognise this cost of equity-settled share-based payments at all. As such, the statement of cash flows fails to capture an important element in assessing performance that is recognised in accruals- based statements.

Bringing forward receipts

Companies can manipulate cash flow from receivables in a number of ways, including settlement discounts, factoring, invoice discounting and securitisation. Such manipulation is at the discretion of the directors in the same way, if not to the same extent, as revenue recognition in the statement of profit or loss and other comprehensive income. Both practices have the problem of 'sustainability', but they can artificially inflate short-term measures of performance.

Assessing the quality of cash flows is perhaps as difficult as assessing the quality of earnings, although for different reasons. Forecasting **future** cash flows is key to financial analysis and corporate valuation. However, historical cash flows are not necessarily any better than historical earnings in achieving this – and in many cases they are worse. In any case, restatement and normalisation is as difficult as it is necessary.

From a valuation perspective, the normalised cash flow and earnings figures are used together to estimate the free cash flows of a business. It is the free cash flow that is discounted to deduce an enterprise value for the business.

6 Financial ratios interpretation

Section overview

This section discusses issues of interpretation of ratios, including those based on cash flow data.

Ratio analysis is the most potent tool of financial analysis. Ratios reduce the dimensionality of the information provided in the financial statements by summarising important information in relative terms. Ratios are based primarily on financial information from the financial statements which, as we have already discussed, can be manipulated by the management of a company. Attention should therefore be paid to the accounting quantities that determine the financial ratios.

6.1 Interpretation of ratios

Some of the ratios that are used in financial analysis, beyond the accounting problems that have been identified, convey very little information if the underlying business operation is not well understood. Good examples are both the trade receivables and the trade payables ratios. A large sale, or a large receipt, immediately before the year end may distort the trade receivables ratio.

Furthermore, the year-end receivables figure is likely to depend far more on the sales in the final month of the year rather than the average. If the final month is unusual (eg, owing to seasonality or growth), the ratio may convey very little information.

The trade payables ratio can be extremely misleading, as it is purchases that generate payables rather than cost of sales. Even if a purchases figure is used, however, this is only possibly valid for retail companies. For manufacturing companies, cost of sales includes not only raw material costs but also production labour costs and overheads, many of which are unrelated to trade payables. This is, thus, a poor ratio to use for manufacturing companies.

A second example is the gearing ratio. It has already been discussed that both non-current assets and liabilities should reflect fair values. In addition, this ratio can be useless as a relative measure unless the operation of the company is well understood. For example, many service-based companies may be 'asset light'. This might include, for instance, IT and internet companies which may have intangibles such as intellectual property rights, but would normally borrow primarily on the strength of their tangible asset base. This may give the impression that the risk of insolvency is higher than in reality and shows that to assess solvency, much more information is needed, such as: the realisable value of assets on sale; timing of debt redemption; conversion rights; replacement or additional financing capacity.

In what follows we concentrate on the problems that arise when the return on invested capital is calculated.

Return on capital employed (ROCE)

It is common for the return on invested capital to be decomposed into its constituent parts using the so-called DuPont analysis, as follows

ROCE = Profits ÷ Capital employed = (Profits ÷ Revenue) × (Revenue ÷ Capital employed) = Profit margin × Asset turnover

To understand what determines the ROCE we need to understand what determines the profit margin and the asset turnover. There are two issues here that need to be assessed. The first is the source of the return on capital, ie, whether it comes from a high profit margin or a high asset turnover. This distinction is important when comparing companies. The second issue is the understanding of the problems associated with the construction and interpretation of the constituent ratios. As was discussed already in strategic analysis, beyond the accounting issues, the financial ratios need to be seen in the context of the overall strategy of a firm both in the medium and the short term.

Profit margin in retailing and manufacturing

A key figure in all the profit margin ratios is cost of sales. This figure is, however, rather different for retailing companies and manufacturing companies. For retailing companies, most of the cost of sales is made up of the cost of buying goods which are later sold in the same condition. One might, therefore, expect issues such as pricing policy, product mix and purchasing activity to affect gross profit margin, but otherwise this figure should be reasonably comparable for companies in the same industry operating in similar markets.

For manufacturing companies, however, the 'cost of sales' figure is more difficult to assess, as it includes all costs in bringing goods to their final location and condition. This includes costs of production, as well as the costs of raw materials. As a result, the gross profit margin for manufacturing companies needs to consider additional factors to those of retail companies that relate to operating efficiency. In particular, it is important to consider the increased possibility of manipulation of inventory value and gross profit through allocations of overheads.

Profit margins – the base data

While profit margins, in effect, consider the relationship between two figures, it is important to understand the individual 'line items' that make up these ratios. Without this, it is difficult to answer such fundamental questions as why revenue has decreased.

Part of the story is in understanding the type of industry, as in the previous section but, in addition, it is necessary to understand the strategy that drives the numbers and the accounting rules that dictate the way they are recognised.

The following is a guide to the factors to consider in determining operating profit.

Revenue

- How is revenue changing – is there a consistent pattern over time? At what rate is revenue increasing/decreasing?
- Is the change in revenue consistent with announced price changes?
- Has sales volume been a factor eg, new competitor, industry trends, cycles, production capacity constraints, inventory accumulation?
- Has the sales mix changed between high-margin and low-margin products?
- Have new products been launched?
- Effect of disposals or acquisitions?
- Effects of currency translation on revenue?

Cost of sales

- Retail or manufacturing
- Impact of raw-material price changes
- Foreign currency changes
- Labour changes – wages rates or quantity of labour
- Impact of overhead costs
- Changes in inventories between opening and closing can affect overhead allocation between profit and closing inventory

Other costs

- What are key costs (eg, R&D for pharmaceuticals, bad debts for banks)?
- Marketing and advertising costs – are these related to revenue changes?
- What proportion of costs is fixed (eg, administration)?

Fixed costs versus variable costs

Fixed costs are those that do not change significantly when sales volumes change. Variable costs are costs that tend to change in line with sales volumes. Unfortunately, IAS 1 does not require companies to disclose which costs are fixed and which are variable. However, certain costs may be regarded as fixed (eg, long-term lease rentals, depreciation and, perhaps, even labour costs in the medium term). Other costs, such as raw materials, are likely to be variable.

It is clear that some industries have high fixed costs, eg, hotels and leisure, airlines, train and bus operators, and heavy industry processes such as glass and steel manufacture. These types of company have high 'operating gearing', which means that profits are sensitive to changes in sales volumes.

This topic of sensitivity is dealt with in more detail below, but for now it is important to appreciate that the relationship between revenue and profit is not linear as revenue changes. Financial analysis should, therefore, expect profit margin changes with sales volumes, and should expect differences in comparing large companies with smaller companies because of efficiency in the use of the asset base.

Intercompany comparisons of profit margins

Any assessments of the value of the ratios are only valid after comparisons with industry norms, or similar competitor companies, as cost structures will vary significantly from industry to industry, so there are few absolute benchmarks.

Rivals will often be similar but they are unlikely to be identical, and many types of differences can occur. These may include differences in:

- size
- product mix
- market positioning, or market strategy
- cost structures
- accounting treatments that have not been possible to standardise precisely
- timings in product life cycles, or business life cycles

While it is important to identify inter-firm differences when calculating profit margin ratios, it is necessary to treat such figures with care.

Activity ratios

Asset turnover ratio

The main activity ratio is the asset turnover ratio, which has been defined in section 1 as revenue over capital employed. However, as activity ratios measure the efficiency with which the assets have been used in generating revenue, the relationship between assets and revenue is only valid for the types of assets which help to generate revenue ie, 'operating assets'. These include: non-current assets, intangibles, inventory and receivables. Investments do not generate revenue, so no logical relationship exists with respect to this type of asset. Thus a more appropriate asset turnover ratio might be a ratio that is based on non-current assets.

Non-current asset turnover ratio = Revenue ÷ Non-current assets

This is one of the most problematic ratios in comparing different companies because companies in different industries vary vastly in terms of the proportion of their assets in the statement of financial position that gives rise to revenues. For a large number of companies in the service industries, such as advertising or financial services, there may be few assets, with revenue being generated by off balance sheet 'assets' such as human resources. In this case, there is likely to be a weak and largely meaningless relationship between revenue and non-current assets. Conversely, in heavy industries such as engineering, non-current assets and their efficient use are key to generating revenue and profits, and thus a much more meaningful relationship exists.

Some problems which arise when we use the non-current asset to turnover ratio are as follows:

- Assets must be revalued to compare like with like.
- Assets added late in the year will contribute little to revenue, so the average of opening and closing non-current assets should be used.

Inventory turnover ratio

The inventory turnover ratio should also be applied with caution. A high number of inventory days may indicate that sales forecasts are not being met, or that there are other marketing-based problems that mean inventories are not being sold as planned. This might be a cause of concern for analysts if it is out of line with competitors or with previous periods.

The ratio is also useful as an inventory-efficiency measure. If the number of inventory days is high, then it might raise the question of whether inventory is being managed appropriately, although the precise level will vary from industry to industry. Industries that have just in time supplying, or make goods to order, are likely to have the lowest inventory days. Moreover, some industries sell at a high profit margin but only sell infrequently. Other companies sell at a low profit margin but, as a result, aim to turn inventory around quickly.

Where a business is growing, it might be appropriate to take the average of opening and closing inventories, rather than the closing inventories alone.

Problems with this ratio include:

- it can be easily managed as inventories can be run down towards the year end, but maintained at high levels the rest of the year; and
- if a business is seasonal, then inventories will vary at different times of the year, and the ratio may say little.

6.2 Cash flow ratios

As the discussion so far has shown, there are potentially serious problems with the use of accounting-based ratios. An alternative set of ratios based on data from the statement of cash flows have been proposed, known as cash flow ratios.

As the name suggests, these are ratios that are based not on accounting data from the statements of financial position or comprehensive income but on cash data. Although these ratios are free of the vagaries of accounting figures, one must be cautious of cash flow ratios in much the same way as accruals-based ratios taken from financial statements. While cash flows may not be subject to the same type of manipulation as accounting data, they can be distorted by management, as noted above.

More importantly, understanding cash flow is about understanding the inflows and outflows over time. Capturing a snapshot in a ratio is potentially misleading without an understanding of the underlying dynamics of the business. Nevertheless, cash flow ratios may at least highlight some issues and raise questions even if they do not provide many answers.

6.2.1 EBITDA

Earnings before interest, taxes, depreciation and amortisation (EBITDA) is perhaps the most commonly quoted figure that attempts to bridge the profit–cash gap. It is a proxy for operating cash flows, although it is not the same. It takes operating profit and strips out depreciation, amortisation and (normally) any separately disclosed items such as exceptional items.

EBITDA is not a cash flow ratio as such, but it is a widely used, and sometimes misused, approximation. Particular reservations include the following:

(a) EBITDA is not a cash flow measure and, while it excludes certain subjective accounting practices, it is still subject to accounting manipulation in a way that cash flows would not be. Examples would be revenue recognition practice and items that have some unusual aspects but are not disclosed separately and, therefore, not added back.

(b) EBITDA is not a sustainable figure, as there is no charge for capital replacement such as depreciation in traditional profit measures or capital expenditure (CAPEX) as in free cash flow.

6.2.2 EBITDA/Interest

This is a variant of the interest cover ratio referred to in your earlier studies and the overview. It uses EBITDA instead of operating profit on the grounds that EBITDA is a closer approximation to sustainable cash flows generated from operations.

6.2.3 Total Debt/EBITDA

This ratio looks at how difficult a company finds it to service its debt commitments from operations. This figure is often used as the basis of a lending covenant by a bank to a company. The higher the ratio, the higher the perceived risk of default on the loan.

6.2.4 Operating cash flows

This shows the ability to generate cash from assets. Again this is similar to calculating the ratio of operating profit to revenue or to total assets.

Operating cash flows = (Net operating cash flows ÷ Revenue) × 100%

This ratio is the amount of cash generated relative to sales. Revenues can also be adjusted by opening and closing receivables so that both the numerator and the denominator are in cash terms. Essentially, this is the cash flow equivalent of 'operating profit/revenue', but it should be greater as operating profit is stated after depreciation whereas there is no equivalent charge for non-current assets in net operating cash flows.

An alternative ratio to look at is:

Operating cash flows = (Net operating cash flows ÷ Total assets) × 100%

6.2.5 Investment cash flows

Investment cash flows = (Net operating cash flows ÷ CAPEX) × 100%

This is a ratio showing CAPEX cover, ie, the number of times CAPEX is covered by operating cash flow. In a service industry this ratio would be high, whereas in a capital-intensive industry a lower ratio would be expected in most years. Where CAPEX is variable from year to year, the ratio is likely to be volatile, so it is particularly important to look at a trend over a number of years.

6.2.6 Financing cash flows

'Financing cash flows' normally concern the availability of cash to repay debt (ie, the free cash flow). This can be defined in a number of ways, and free cash flow measures (eg, net operating cash flows less CAPEX) would be one proxy.

Debt repayments (in years) = Total debt ÷ Free cash flow

This ratio shows the potential to repay debt in a given time, rather than when debt will actually be repaid.

Cash flow interest cover = Free cash flow ÷ Interest payments

As noted above, this shows the number of times interest payments are covered, but after replacing non-current assets.

Debt servicing = Free cash flow ÷ (Interest + Principal payments)

This shows the number of times interest and capital repayments (where debt is repayable by instalments) are covered, after replacing non-current assets.

6.2.7 Market to book ratio

This is not a cash flow ratio but the market value element is free of accounting distortions. The market to book ratio shows the relationship between the going concern value of the company, and the carrying amount of its net assets. It thus reflects asset backing. This ratio is likely to be highest for companies with unrecognised intangible assets, such as IT companies. If non-current assets have not been revalued, this would also increase this ratio. A ratio of less than 1:1 is common in some industries such as investment trusts, but otherwise it may indicate going concern issues or, possibly, asset-stripping potential.

Market to book ratio = Market value of equity shares ÷ Carrying value of equity (ie, net assets)

7 Forecasting performance

Section overview

This section presents a number of methodologies for forecasting the future performance of a company and discusses the various issues involved, such as aggregate versus disaggregated forecasts and the forecasting of the effects of discrete events such as mergers and acquisitions.

Once the data from the financial statements of the company have been adjusted and through the analysis of the firm's business strategy the drivers of sustainable earnings have been identified, then the future performance may be predicted taking into account the future macroeconomic and industry conditions.

7.1 The production of forecasts

The production of financial forecasts is based on a model of business operation which attempts to identify the long-term drivers of growth of a company. To identify these drivers, a historical analysis of the company should be undertaken based on the financial information derived from company accounts and market data. To obtain the right picture we need to follow the steps of accounting analysis and possible restatement of the accounts as explained in the previous section. We also need to perform a strategic, competitive and corporate analysis in order to assess the underlying economic conditions of the company.

Growth drivers and business strategy

The growth drivers are the factors that affect the revenues and costs of an enterprise and hence its earnings. To understand these drivers, and how they will change over time, it is essential that the analyst understands a company's business model. This includes understanding:

- the main strategies available to the company
- its product or service
- its manufacturing technology and production methods

- its marketing strategy
- its knowledge and skills base
- the competitive and industry environment within which it operates
- its competitive advantage within an industry (if any)
- the durability of that competitive advantage
- the regulatory and other constraints on the company

The analysis of the business strategy would explain certain characteristics of the firm, for example high profit margins due to competitive advantages. Similarly, higher efficiency will be reflected in better activity ratios. However, forecasting is not a mere extrapolation of the past. The future industry conditions as well as the future macroeconomic environment will be a significant factor in the determination of performance.

Industry conditions

The industry conditions that may affect the performance of a company include:

- price competition
- product/service innovation
- marketing and distribution innovation
- technology, and cost reduction
- quality improvement
- imitation
- new entrants
- diversification
- mergers and acquisitions

7.2 Forecasting revenues

Revenue is normally the starting point in setting up a forecasting model. As in the case of earnings, though, we need to find the sustainable revenue figure to forecast. Revenues can be forecast either for the whole company or according to IFRS 8, *Operating Segments* for each business or geographical segment.

Segment reporting allows separate revenue and profit margin forecasts to be made for each segment, together with a separate analysis of risk. These could then be aggregated to produce a more accurate company-wide performance forecast. There are many methods to forecast revenues, and we shall review some of them below.

7.2.1 Market share method

In the market share method, the assumption made is that the share of a company's sales in the industry remains stable. Forecasting takes place in two stages. In the first stage, the sales for the whole industry are forecast. In the second stage the revenue of a specific company may be predicted using its market share.

Industry revenue can be predicted by postulating a relationship between industry sales and some macroeconomic aggregates such as gross domestic product (GDP), inflation rate, interest rates or tax rates.

An alternative method of forecasting industry revenue is to identify microeconomic factors that affect the demand and price of the products of an industry. These include factors such as the price and income elasticity of demand for the products of the industry, seasonality in demand and any other factors which are particular to the industry.

Interactive question 1: Forecasting revenue

You are given the following information on GeroCare, a company operating for the last 10 years in the healthcare industry.

Year	Industry sales	GeroCare sales
	£m	£m
20X2	1,200	180
20X3	1,325	198
20X4	1,450	218
20X5	1,600	240
20X6	1,780	264

Requirement

If industry sales are expected to grow by 20% in 20X7, what is a reasonable forecast for the GeroCare sales in 20X7?

See **Answer** at the end of this chapter.

Note: The above example is fairly simple for illustrative purposes, but were a forecasting exercise to have many variables, excel could be used so that all the figures did not have to be recalculated when one or more item changes.

7.2.2 Modelling company-specific revenue

An alternative approach to forecasting revenues, which may be more appropriate for a company which does not have a stable market share, is to construct a model for a specific company, which makes revenues a function of various factors. The factors that affect revenue generation normally are:

CAPEX

In stable markets, revenue growth comes from expanding the volume of sales and this comes either from increased productivity, or more commonly from new investment for replacement of existing capital or expansion. Thus CAPEX is a key variable that impacts on revenue. Where a company is expanding its non-current asset base by engaging in CAPEX in excess of that needed merely to sustain its asset base, one might expect additional revenues to be generated.

The impact of this increase needs to be modelled by the relationship between non-current assets and revenue. The existing relationship is captured as we have seen in earlier sections by the non- current asset turnover ratio. The key question in modelling this is whether this ratio remains fairly constant over time.

The acquisition of intangibles

The acquisition of intangibles would clearly impact on revenue forecasts. If a company were to acquire a valuable brand, then revenue might be expected to increase as a result, independently of any other factors. However, as IAS 38, *Intangible Assets* stands, it creates problems of recognition and measurement of intangible assets. Indeed, the problem is not so much assessing the revenue impact of recognised intangibles as attempting to model the impact and value of off balance sheet intangibles.

7.3 Forecasting costs

The key factor in modelling costs is to determine the profit margin. This involves establishing a relationship between costs and revenues.

Fixed costs and variable costs

One possible approach is to separate out cash costs from accounting costs. To the extent possible on the basis of public information, the cash costs should then be separated into fixed costs and variable costs. This is because revenue grows over time (if indeed it does), but not all costs behave linearly, and it is important to have a clear idea how costs are to change in relation to revenues.

Non-cash items in recurring earnings include depreciation and amortisation. These may be regarded as fixed costs, and are dealt with in more detail below.

In terms of other costs, the standard line by line presentation in published financial statements does not make a ready distinction between fixed and variable costs, so estimates need to be made.

While all costs tend to be variable in the longer term, for large changes in revenue, there are some costs which do not vary proportionally with sales in the short run. This is not to say that they do not change at all, as inflationary and other factors may impact on them. They should be adjusted independently of other variable costs, and using separate considerations.

Potentially the largest fixed costs are employment costs, although much will depend on how employees are paid and the company's current policy on recruitment or redundancies, but this comes back to an analyst's knowledge of the business. Fortunately, employee costs are separately disclosed under IAS 19, so these costs can be estimated separately.

One difficulty is that, for a manufacturing company, cost of sales includes fixed cost and variable cost estimates, and it is not always clear which employee costs are included and what proportion of employee costs has been rolled into inventories.

The major variable cost is often raw materials, although this varies from industry to industry. For retail companies, the assumption that cost of sales is entirely variable is normally reasonable, and there are fewer problems.

Operating leverage

The separation of fixed and variable costs in forecasting helps these costs to be separately modelled according to the factors that drive them, but it also has another purpose. The relationship between fixed and variable costs, once established, can be used to estimate a company's operating gearing, and this has important implications for risk assessment.

In essence, operating gearing means that the greater the level of fixed costs, then the more variable the profit margin as revenue changes. Thus high operating gearing means high risk from revenue changes.

As a result, for high operating gearing firms in particular, profit margin is unlikely to be proportional to revenues where there is growth, or a decline. For example, a manufacturing company with high fixed costs will more than double profits if sales double, as fixed costs do not increase with the extra sales.

Structural changes

In modelling cost structures, care needs to be taken that there are not structural changes in the company, or the industry, within the planning horizon, that will alter the overall level of costs or the balance of fixed and variable costs.

These changes may be difficult to foresee, but may include:

- technology changes

- sale and leaseback arrangements
- shifts in the product mix – perhaps identified in segment disclosures
- increased CAPEX to replace labour

Any known disclosure by the company or trends should be considered in this respect.

7.4 Forecasting non-current assets, depreciation and CAPEX

The significance of non-current assets varies from industry to industry. For some service industries, they are immaterial, and thus very simple assumptions will suffice. For heavy manufacturing industries, where there are cycles, there are many more problems.

It is not just the level of non-current assets that matters. Some companies have a large number of small items, while other companies may have a small number of large items (eg, oil rigs). Similarly, one non-current asset may be acquired as a unit, but be replaced and depreciated in several components.

As already noted, the relationship between non-current assets and revenue is important. The impact is likely to vary from industry to industry, but it needs to be established whether the company is growing, the demands this will make on CAPEX, and the nature of the non-current asset turnover ratio in measuring the efficiency with which non-current assets generate revenue.

The simplest assumption – that revenue and non-current assets will vary linearly (ie, the ratio is constant) – may be reasonable in many cases. If so, it gives us a CAPEX forecast, as well as helping with a revenue forecast. However, caution must be exercised in this assumption.

Thus, if we can forecast depreciation, then we can forecast the CAPEX to sustain non-current assets, and the additional CAPEX necessary to accommodate growth. For this to be valid, however, depreciation will need to be based on fair values rather than historical cost, but this should have resulted from our earlier standardisation process.

A key forecasting error can be to obtain reasonable profit projections but underestimate the CAPEX required to sustain and grow the business. Given that free cash flow is essentially calculated as cash from earnings less CAPEX less working capital changes, then this can result in an overvaluation of a business. Thus, a valid depreciation forecast is crucial in this respect, even though it is not, of itself, a cash flow.

Depreciation can be difficult to forecast, as different assets are depreciated at different rates and, although IAS 16 requires disclosures, they are frequently ranges of asset lives rather than for each individual asset.

Estimates can be made from the gross asset values where straight-line depreciation is used, but this assumes that no assets are already fully depreciated. Alternative methods are to estimate average lives for each type of asset or remaining lives.

If asset lives are not too long, we can retrace the additions to each type of non-current asset from previous years' financial statements, then attempt to model forward separate depreciation charges, disposals and other types of derecognition. Any disclosed profit or loss on disposal may give an indication of whether depreciation policies are proving inadequate or overprudent.

In terms of CAPEX, to grow the business – rather than merely compensate for depreciation – it is important to develop growth or no-growth scenarios over the planning horizon. More obviously, however, for the forthcoming 12 months companies may disclose, in the notes to the financial statements, the level of capital commitments entered into, and this can be used as an element of a short-term CAPEX forecast.

Intangibles amortisation can be forecast in the same way, although in this case there needs to be more care with unrecognised expenditure under IAS 38. Although unrecognised as an asset, such expenditure may have important implications for future revenue, and costs and will need to be modelled separately.

Interactive question 2: Forecasting capital expenditure

SouthWest Electric is an electricity supplier in England. Revenues have been stable for the last five years and all the capital expenditure has been dedicated to updating its network. Approval for the creation of a new town of 50,000 people has been given by the Government and SouthWest Electric expects sales to increase by 15% over the next five years.

Requirement

Which of the financial ratios will you use to get a rough idea of the capital requirements of SouthWest Electric, and what are the factors that may affect its accuracy?

See **Answer** at the end of this chapter.

7.5 Forecasting working capital needs

Working capital is needed to sustain the business, and constantly needs to be replaced. If the business is not growing, then the cost of circulating working capital is already included in the profit forecast. If, however, the business is growing, then it is likely that more investment in working capital will be needed. For example, if revenue is increasing, then more inventories are normally needed to supply customers, and more receivables will usually arise from increased sales. The increase in working capital as a business grows can thus be viewed as an additional cash expenditure on financing the incremental working capital. Conversely, if a business is declining, then working capital is released, generating additional cash.

The simplest way to forecast changes in working capital requirements is to assume a linear relationship between changes in working capital and changes in revenues. This can be achieved using an appropriate financial ratio. Using the historical ratio values and revenue changes as the driver, non-cash working capital needs can be estimated. These then become part of our forecast free cash flow estimation.

There are other components of working capital such as prepayments and accruals, but these normally have little causal relationship with revenue drivers and should therefore be considered on the basis of individual circumstances.

7.6 Forecasting equity

The simplest forecast model is the so-called 'clean surplus' model, according to which any changes in equity result merely from retained profits. Equity at the end of a period is equal to the beginning of period value plus earnings minus dividend payments. With dividends being determined by management, equity is simply determined by earnings.

The 'dirty surplus' model, on the other hand, assumes that equity is affected by items of other comprehensive income. These items are likely to prove difficult to estimate, unless there are some known or systematic effects (eg, with the foreign currency translation of an overseas subsidiary).
Much will depend on understanding the particular circumstances of individual companies in this case.
In addition, changes in equity include capital items such as new share issues and share buybacks. These changes in the equity capital of a company should be considered when forecasting statements of financial position, as they change the financial structure of the company.

Unfortunately, unless the company has announced a share buyback or a share issue, then any attempt to forecast these is largely guesswork. Even if a share issue, or a share buyback, seems likely within the forecasting horizon, the timing is at best uncertain. Similarly, the pricing of any issue or buyback is unknown, as the current share price is unlikely to be a good predictor of future price, which is itself uncertain.

Interactive question 3: Forecasting equity

At the reporting date of 31 December 20X6, equity capital for Granthar plc was £50 million. The company predicts earnings of £27 million for 20X7 and has announced a dividend for 20X7 of 20p per share. There are 40 million shares issued.

Requirement

Using the clean surplus model what is your prediction of the level of the company's equity at 31 December 20X7?

See **Answer** at the end of this chapter.

7.7 Forecasting funding requirements

Forecasting funding requirements is equivalent to forecasting the needs of the company in long- term debt, short-term debt and cash. Some models simply forecast net debt as a single item which arises from the operating and investment activities and working capital needs of the company. This simple approach leaves open the question of how, specifically, the funding will be put in place, and loses key pieces of information available in the financial statements, such as maturity dates on existing debt.

One approach is, therefore, to consider how long-term debt will be raised, and how it will mature. Long-term debt is thus the independent variable. Short-term debt and cash are therefore the residuals (or the dependent variables) needed to match the funding needs from other forecasts.

7.8 Forecasting and acquisition and consolidation

In most situations of financial analysis of listed companies it will be necessary to evaluate not an individual company, but a group of companies. In order to do this it is necessary to understand the impact of consolidation on performance forecasting, and the potential for value creation (or value destruction) in mergers and acquisitions.

The following table provides a summary and reminder of the different types of investment and the required accounting for them:

Investment	Criteria	Required treatment in group accounts
Subsidiary	Control (> 50% rule)	Full consolidation (IFRS 10)
Associate or joint venture	Significant influence (20% + rule)/joint arrangement where parties with joint control have rights to net assets	Equity accounting (IAS 28)
Joint operation	Joint arrangement where parties with joint control have rights to assets and obligations for liabilities	Line-by-line recognition of assets, liabilities, revenues and expenses (IFRS 11)
Investment which is none of the above	Asset held for accretion of wealth	As for single company accounts (per IFRS 9)

IAS 28 requires that associates and joint ventures should normally be accounted for using the 'equity method'. Equity accounting is sometimes called 'one-line consolidation', as there is only one amount shown for an associate in profit or loss (being the parent company's share of the associate's profit), and one amount shown in the statement of financial position (being the cost of investment plus share of post-acquisition reserves).

As the statement of cash flows begins with profit before tax, it already includes the parent's share of the associate's profit. It is, therefore, necessary to adjust the associate's profit so that only the dividends from associates are recognised.

In terms of modelling the associate's contribution to the group, it is normal to consider the associate separately, as it is likely to be affected by different factors from other group revenue and group margins.

7.9 Forecasting the impact of mergers and acquisitions

Modelling would normally assume that there are no major structural changes. Thus, when a merger, acquisition, disposal or spin-off takes place, the forecasting model needs to be amended to take account of these changes. For a company that acquires another company, there are two major effects that need to be incorporated in the forecasting model. These are synergies and the financing of acquisition.

There are three types of synergies that must be modelled:

(a) Synergies that lead to revenue enhancement

(b) Synergies that lead to cost reduction

(c) Synergies that lead to capital efficiency

Revenue enhancement

Revenue enhancement can come from a range of beneficial factors including increased market presence; enhanced market power; cross-selling opportunities; reduced price competition; and improved ability to service customers.

It might be noted, however, that most of these factors refer to horizontal integration where the acquisition is made in a similar or overlapping market. Where there is vertical integration, such as where a company buys a major customer or supplier, then there is a perverse effect that consolidated revenue in the financial statements may fall. This is because sales from one group company to another are not external sales, and are not reported as revenue. Cost of sales to the purchasing company will also fall, and so – because of this accounting treatment – profit will not change. However, the profit margin would appear much greater in the consolidated accounts than it was in the sum of the two previously independent companies.

A further note of caution in assessing post-acquisition performance is that where an acquisition takes place during a year, only the post-acquisition element of profit or loss items is consolidated.

Cost reduction

The most obvious cost reductions are common costs, eg, head office and functions such as marketing, administration, treasury and distribution. Other areas include reductions in management and, perhaps, procurement economies in terms of discounts.

In modelling such costs, an assessment will need to be made of the proportion of total costs that can be eliminated in the merged entity.

A word of warning, however, may be necessary. In the period immediately following the merger, there may be reorganisation and integration costs such that, in the short term, costs may actually increase compared with the two independent entities. However, such costs are transitory and do not form part of the normalised earnings of the combined entity. If fully disclosed separately they should be reversed but, if not, an estimate will need to be made.

Capital efficiency

The combined entity may be able to use non-current assets more efficiently, thus enabling some disposals to take place or at least reductions in CAPEX in the short term. Similarly, there may be more efficient use of inventories where there is some overlap of product ranges, resulting in greater working capital efficiency. This might well be a significant value driver for forecast synergies.

Financing the acquisition

It is important to separate out the investment decision from the finance decision in modelling any acquisition.

An extreme case is a leveraged buy-out where most of the cash to make the acquisition is borrowed in the expectation that future operating profits will be sufficient to repay the debt and interest. In these circumstances there is likely to be a significant increase in financial risk, due to increased financial gearing. As such, the financing cash flows and net debt need to be considered carefully, as does the discount rate that must be used in relation to forecast operating flows.

7.10 Forecasting the impact of reorganisation and reconstructions

Companies periodically tend to change the scope and nature of their existing activities as part of strategic change projects. This can involve reconstructing, reorganising, downsizing, cost reduction exercises and similar schemes. The intention of such schemes is normally to improve profitability in the short or long run and, ultimately, to add value to the business.

When such schemes are announced, however, analysts need to estimate the impact of these changes on value. Financial analysis, and financial disclosures, are part of the jigsaw in making such estimates of value creation (if any) arising from the changes.

If a closure, withdrawal or reconstruction relates to a separate segment which is separately disclosed under IFRS 8, then the impact, at least historically, is isolated. Reasonable predictions can then be made of the consequences of the closure, withdrawal or reconstruction. Unfortunately, such happy coincidences are rare, and it is more likely that financial statements will provide only some general clues as to the consequences of reconstructions, even when used alongside other available information.

Nevertheless, the above performance forecasting methodology can be used to estimate changes in future profits arising from a reconstruction and thereby help to assemble a revised valuation for the company.

Moreover, in the set of financial statements published after any material reconstruction, financial reporting disclosures can provide additional, if retrospective, information about the consequences of any reconstruction (eg, exceptional items under IAS 1). Any initial forecasts can then be amended to re-evaluate longer-term valuation consequences.

Key point summary

- When a merger, acquisition, disposal or spin-off takes place, there are important effects that will need to be reassessed by forecasting performance in the context of the proposed changes in ownership, structure and financing.
- Synergies enhance value: These may include revenue enhancement, cost reduction and capital efficiency.
- Financing the acquisition: It is important to separate out the investment decision from the finance decision as, in modelling any acquisition, these will have separate effects.
- Operating decisions impact on value creation: Two key value drivers are profit margins and asset activity. These can be analysed by the use of accounting ratios.
- Financial reporting information, alongside other sources of information, can help estimate

the impact of reorganisations and reconstructions on corporate value.

7.11 Forecasting the effects of funding policy

Financial statement analysis can help analysts measure and model some of the consequences of financing decisions for valuation. In so doing, financial statements can act as one input into valuation models to assess how corporate values are affected by financing decisions.

Raising equity finance in a perfectly efficient capital market should not impact on value. Economic theory tells us that it is operating and investing activities, not financing decisions, that impact on value. The reason for this is that value creation is not about increasing the value of the company: it is about increasing the wealth of the shareholders. Raising new equity at market value in an efficient market will increase the value of the company, but only by the value of the share issue, leaving shareholder wealth constant. Share price would be constant if the shares were issued at market value.

However, to the extent that markets are not efficient, financing can impact on shareholder value. If, on the basis of inside information, directors perceive that market prices are in excess of the intrinsic value of shares, then a share issue may add to the wealth of existing shareholders.

Conversely, if directors perceive that market prices are lower than the intrinsic value of shares, then a share repurchase may add to the wealth of existing shareholders.

This is not the same as saying that, when a share issue is announced, share prices may change. This will depend on the 'news' value on the announcement day, and any perceived positive net present value from the project that is being financed by the share issue.

The role of financial statement analysis is that the new shares, the new cash flows from any project, and any changes in financial or operating risk can be built into a model to provide new forecasts of the value creation of the new financing and associated operations.

7.12 Forecasting scenarios and sensitivity analysis

Having made a range of individual forecasts, it might seem logical to assume that the overall outcome will be reasonable. Unfortunately, this is not necessarily the case.

The estimates are likely to be single values, or 'point estimates', which only really represent our 'best guess' from a range of possible outcomes in each case. Once these point estimates have been put together, however, it is necessary to test the reasonableness of the whole picture to ensure that, for instance, we have not estimated revenues at one end of a reasonable range and CAPEX at the other end of its reasonable range, producing an unreasonable and inconsistent result.

One way to test the reasonableness and consistency of the forecast figures is to recompute the basic ratios based on the forecast figure, to see if they make sense.

Another feature of checking reasonableness is to consider various scenarios and see if the modelled figures change significantly when the scenarios change. This might include some strategic effects, such as a new entrant into the industry, declining industry demand perhaps due to new substitutes, or suppliers forcing price increases for raw materials.

7.13 Risk assessment

In order to assess the impact of estimation errors, sensitivity analysis is a useful tool, but it does not say how probable the alternative outcomes are, and does not of itself measure risk.

Consideration should, however, be given to risk and the potential for variation in the estimate that has been forecast. Consideration can be given to the following:

(a) How well diversified is the company (eg, does it depend on one product or service)?

(b) Volatility of earnings can be specifically measured using standard deviations.

(c) If the business is cyclical, do the variations change according to the economic business cycle and is the risk largely systematic? If so, an accounting beta can be estimated by plotting the covariance of a company's earnings against an index such as market earnings of FTSE 100 companies, or even GDP variation.

(d) If the business is risky, is it appropriate to make prudent estimates of variables in forecasting performance? This may, however, just result in a pessimistic forecast without regard for upside variation.

If the risk is default risk, then an assessment of the company's liquidity arrangements, including contingent funding, may be appropriate. Credit rating agencies, such as Standard & Poor's, or Moody's, may also give an indication of default risk.

7.14 Cash flow forecasting and valuation

The end product of forecasting is normally the valuation of an enterprise based on discounting future cash flows. The forecasting process has, therefore, taken earnings and figures in the statement of financial position and produced a free cash flow forecast. From this, appropriate risk-adjusted discount rates can be used to determine value, or test the value creation of various strategic and corporate finance decisions. The internal rate of return can also be used, based on cash flows, as the economic equivalent of ROCE.

The end product of financial analysis is the understanding of how value is created and how forecasting earnings can be built into valuation models to assess the impact of different operating investment and financing decisions. The last issue requires the use of excel file models that capture the relationship between drivers and value.

Value creation can be affected by a variety of investment, operating and financing decisions taken by a company. This section looks at examples of some of these decisions, and considers the role of financial analysis in assessing the consequences of such decisions for value creation by those external to the company concerned.

Having made forecasts, then other cash flow measures such as payback can also be used or, similarly, other expressions of profit and adjustments thereto can be made such as economic value added (or EVATM).

Although we have concentrated so far on forecasting individual figures for the statement of profit or loss and other comprehensive income or the statement of financial position, the most common use of forecasting financial statements is to produce a valuation of the entity.

The quantity that is forecast for valuation purposes is the free cash flow to the firm defined as

FREE CASH FLOW = FCFF = EARNINGS BEFORE INTEREST AND TAXES (EBIT)

Less: TAX ON EBIT

Plus: NON-CASH CHARGES Less: CAPITAL EXPENDITURES

Less: NET WORKING CAPITAL INCREASES Plus: SALVAGE VALUES RECEIVED

Plus: NET WORKING CAPITAL DECREASES

The future FCFF will need to be discounted using an appropriate discount factor that will be consistent with the risk of the cash flow.

8 Data and analysis

Section overview

Professional accountants have to use their common sense and judgement when they analyse data. They are often required to draw conclusions or make recommendations on the basis of information in business reports and financial statements. The analysis of such data is normally both quantitative and qualitative. It is important that accountants should be aware of the limitations of any data they are using when they make such conclusions or recommendations.

8.1 What is data?

The word 'data' has several meanings. It is commonly associated with input to a computer, or 'raw data' which is processed to obtain meaningful information. For the purpose of this chapter, a useful definition of data is: 'Facts from which other information may be inferred'.

Professional accountants are often presented with reports and statements, from which they are expected to identify issues and draw conclusions. In other words, they have to analyse the data and consider its implications. Analysis of data is also relevant to the auditor. The auditor will analyse data in the financial statements in order to draw a conclusion which will form the basis of the auditor's report.

Reports and statements vary in nature. They may be **internally produced** business reports or financial reports, as well as externally published financial statements.

8.2 Characteristics of data

A useful starting point is an appreciation of the characteristics or qualities of data. Information should be reliable; but data often **lacks reliability**, for any of the following reasons.

(a) **Incomplete**. Data is often incomplete, in the sense that it does not tell the user everything that he or she needs to know. Incomplete information is a source of evidence, but not enough for the evidence to be conclusive. The user should want to learn more before reaching a conclusion.
Incompleteness of data can be a particular problem with external reports, whose purpose may be only indirectly related to the interests and concerns of the report user.

(b) **Lacks neutrality**. Information may lack neutrality. A report may contain opinions and recommendations that reflect the opinions and bias of the report writer. Professional scepticism may need to be applied in interpreting such data or placing reliance on it.

(c) **Inaccurate**. The data in a report or statement may be inaccurate, or the user of the report or statement may suspect that it is inaccurate. Alternatively, data may be insufficiently accurate for the requirements of the user. Without confidence in the accuracy of data, the user cannot make reliable conclusions.

(d) **Unclear**. Information may lack clarity, especially when it comes from an external source. Lack of clarity may be due to:

(1) **poor expression of ideas** in an external report by the report author, or lack of clarity about the assumptions on which information in the report is based; or

(2) **deliberate lack of transparency** by the information provider. An example of this might be press releases by a competitor organisation, whose statements about a particular item of news may be deliberately obscure without being untruthful

(e) **Historical**. Historical data may be used to make forecasts or conclusions about the future. However, any historical-based prediction is inevitably based on the assumption that what has happened in the past is a valid guide to what will happen in the future. This may not be the case.

(f) **Not up to date**. When events in the business environment are changing rapidly, information may get out of date very quickly. There is a risk that any data in a report or statement is no longer accurate because it is no longer up to date.

(g) **Not verifiable**. Some data or information may not be verifiable. Management may want corroboration of a fact or allegation, but there may not be an alternative source for checking its accuracy. This is often the case in employment disputes at work: two individuals may contest claims made by the other, and there may be no way of checking whose allegations are correct.

(h) **Source**. Information may come from a source that is not entirely reliable. This may be a particular problem with secondary data from external sources.

Accountants must use the data that is available to them, even though it is not 100% reliable. They may have to qualify their opinions or judgements according to their view about how much reliance they can place on it. A major problem is often incompleteness.

Data may **lack relevance** as well as reliability.

(a) There may be a risk of drawing unjustified conclusions from available data, and interpreting data in ways that the facts do not properly justify. The data user may imagine that there is evidence to justify a conclusion, when the evidence from the data is not at all conclusive.

(b) With financial data, there may be a risk of using financial statements prepared under the accruals concept to make conclusions when cash flows and incremental costs should be used.

An accountant may want to use data to make comparisons, such as comparing the performance of different companies or different segments of a business. Unfortunately, data may not be properly comparable. For example, comparing sets of data about the performance of two rival companies may not be entirely reliable because the available data for the two companies:

- has been collected in different ways;
- is based on different assumptions; or
- is presented differently, under different headings.

8.3 Financial data analysis

You could be expected to analyse financial data about any of the following areas:

(a) The financial markets. You may be asked to comment on data about conditions in the financial markets, such as interest rates or exchange rates, and implications of changes in market conditions for the organisation

(b) Revenue, profitability and costs – and pricing

(c) Cash flow or liquidity

(d) Capital structure

If you are given financial data for analysis, you should consider the adequacy or limitations of the information and be aware of what the information does not tell you. What is missing could be more important than what the report or statement contains.

(a) Data about profitability may present product profitability, when you should be more concerned with customer profitability, distribution channel profitability or market segment profitability.

(b) Data about profitability may be provided, when you should be more concerned about cash flow and funding.

(c) Cost and management accounting information may be presented in a traditional format, such as an absorption costing or marginal costing statement, when you may consider that another approach to presenting information is needed – for example, an activity-based costing statement, or information about particular aspects of cost that traditional statements do not analyse, such as quality costs.

The challenge with analysing financial information may be not so much to demonstrate your knowledge of financial analysis as to demonstrate your understanding of the limits of financial analysis when insufficient or inappropriate data is available.

Worked example: Financial data

Wizard Ltd is a specialist component manufacturer for the aerospace industry employing 54 people. It has two main customers located in North America. The relative success of Wizard over the last few years has attracted interest from a number of potential industry buyers. One of Wizard's main customers, Draco plc, is now considering making a bid for the entire share capital of Wizard, effectively bringing Wizard's services in-house. Draco is concerned that the specialist products that Wizard supplies it with allow it to charge, in the words of the Draco purchasing manager, 'outrageous prices'.

The financial adviser to Draco has obtained the following information relating to Wizard.

Extracts from the financial statements of Wizard for 20X5

	$'000
Revenue	14,730
Cost of sales	8,388
Other costs	5,202
Profit before tax	1,140
Profit after tax	798
Dividend paid	390
Non-current assets	5,364
Inventories	1,392
Receivables	876
Cash	192
Payables	1,464
Equity share capital	600
Retained earnings	5,760

Information obtained from the Aeronautical Trade Association

Average P/E ratio (for quoted companies)	9.0
Average annual growth in reported post-tax profits (20X4–20X5)	3.0%
Average pre-tax profit margin	5.1%
Average pre-tax ROCE	13%
Average receivables days	78
Average payables days	34
Average revenue per employee	$154,200

The finance director of Draco has provided the following summary of Draco's recent performance:

	20X5	20X4	20X3	20X2
	$m	$m	$m	$m
Revenue	58.75	55.60	50.30	50.50
Pre-tax profit	4.40	7.15	7.75	10.05
Dividend paid	0.40	2.50	2.50	2.50

Requirement

Analyse the financial position and performance of Wizard as at the end of 20X5.

Solution

Wizard performance

Measure	Industry	Wizard	Workings
Gross ROCE		99.7%	(14,730 – 8,388) / (600 + 5,760)
Pre-tax ROCE	13%	17.9%	1,140 / (600 + 5,760)
Gross profit rate		43.1%	(14,730 – 8,388) / 14,730
Pre-tax profit rate	5.1%	7.7%	1,140 / 14,730
Non-current assets turnover		2.75	14,730 / 5,364
Receivables days	78	22	(876 / 14,730) × 365
Payable days	34	64	(1,464 / 8,388) × 365
Inventory days		61	(1,392 / 8,388) × 365
Revenue per employee $	154,200	272,778	(14,730 / 54) × 1,000
Pre-tax profit per employee $	7,864	21,111	(1,140 / 54) × 1,000
Dividend cover		2.05	798 / 390
Current ratio		1.68	(1,392 + 876 + 192) / 1,464
Quick ratio		0.73	(876 + 192) / 1,464

Analysis

Pre-tax ROCE and pre-tax profit rate – These are 38% and 51% higher than industry average, which supports the view that Wizard is able to charge high prices. This would appear to be a result of the specialism of the services that Wizard provides. Additionally, there may be strict cost control within Wizard, further allowing it to generate higher margins. Should Wizard be acquired by Draco, then the products will be available at 'cost', thereby saving Draco money, while allowing it to potentially benefit from the premium prices it can charge to Wizard's other main customer.

Receivables days – At 22, these are exceptionally low compared to the industry average. This is probably due to the fact that Wizard only has two main customers, making it possible to form close working relationships. Given the specialism that Wizard provides, it is likely that its customers do not want to sour this relationship by delaying payment. There is no reason to believe that this will change if Draco acquires the company.

Payables days – At 64, this is almost twice the industry average and reflects either a strict cash management policy within Wizard, or potentially a cash flow problem. Given the high profitability within Wizard, and its healthy balance sheet, it would appear that Wizard has squeezed its suppliers quite hard. Once acquired by Draco, this strategy may need to change to bring it in line with company policy.

Inventory days – At 61, this indicates the time that inventory is held by Wizard. This demonstrates that the production process within Wizard is about two months and may be a reflection of the complexity of the manufacturing process that it undertakes. It may be a result of the safety checks, which are a key feature of supply in the aerospace industry, and the time taken to do this may contribute to the 61-day figure.

Revenue and profit per employee – These are, respectively, 77% and 168% higher than industry average, which is a further reflection of the profitability and revenue generation abilities of Wizard. This is further evidence of its ability to charge high prices and possibly control costs. Interestingly, we are told nothing about the salaries within Wizard and it may be that as a smaller firm, their salaries may be different to those within Draco. Should Wizard's salaries be higher than Draco's, this could lead to demands for higher wages among Draco's workforce. In terms of costs, it may well be that once Wizard is acquired, the greater purchasing power which a larger company would have may lead to further economies of scale and even cheaper supplies.

Dividend cover – As Wizard is not a listed company, its dividend ratio is not strictly comparable with Draco's. What is relevant is that it evidences Wizard's ability to pay dividends and hence generate cash. This is potentially good news for Draco as it has recently cut its own dividends, which will have disappointed shareholders.

Liquidity ratios – Without industry statistics, these are in themselves fairly meaningless. However, the current ratio is greater than one, indicating good liquidity, and the quick ratio is close to one. Allied with its low receivables and high payables days, this indicates that Wizard does not appear to have cash flow problems.

Overall – It would appear from the above analysis that Wizard is a profitable company that does not appear to have any liquidity or working capital concerns.

The type of analysis performed above may also be performed by the auditor as part of the analytical procedures at the risk assessment stage of the audit. The use of data analytics tools allows this analysis to be carried out at a more granular level than has historically been the case.

Professional skills focus: Assimilating and using information

In approaching a question like this, where there is a great deal of information, it is important to read the background detail carefully before looking at the ratios. This will tell you if you are comparing like with like.

8.4 Approach to analysing financial data

If you are given financial data for analysis, you should expect to carry out some numerical analysis. You will have to decide yourself how to do the analysis.

(a) If you are given data for more than one year, you should measure changes over time. If you are given financial data about a competitor, you should try to make a comparative analysis.

(b) There may be value in carrying out cost-volume-profit analysis (breakeven analysis) on data that you are given, but you will need to state your assumptions about fixed and variable costs.

(c) If you are given information about historical performance and targets, you should try to carry out numerical analysis of the extent to which the organisation is on track for meeting its targets.

Show all your numerical workings and state clearly the assumptions you have made.

Professional skills focus: Structuring problems and solutions

The above approach can be used to structure your solutions to financial analysis questions. Turn data into information and information into analysis and conclusions.

9 Management commentary

Section overview

Some of the limitations of financial statements may be addressed by a **management commentary**. The IASB has issued a practice statement on a **management commentary** to supplement and complement the financial statements

9.1 Need for a management commentary

Financial statements alone are not considered sufficient without an **accompanying explanation of the performance**, eg, highlighting a restructuring that has reduced profits or the cost of developing a new business channel in the current period which will generate profits in the future.

Perhaps more importantly, a good management commentary not only talks about the past position and performance, but also about how this will translate **into future financial position** and performance.

The *Conceptual Framework for Financial Reporting* acknowledges that 'general purpose financial reports do not and cannot provide all of the information that existing and potential investors, lenders and other creditors need. Those users need to consider pertinent information from other sources, for example, general economic conditions and expectations, political events and political climate, and industry and company outlooks.' (para 1.6).

Typically, larger companies are already making disclosures similar to a management commentary, eg, as a 'Directors' Report', but the aim of the IASB is **to define internationally what a management commentary** should contain. For example, a good commentary should be balanced and not just highlight the company's successes.

A management commentary would also address **risks and issues** facing the entity that may not be apparent from a review of the financial statements, and how they will be addressed.

9.2 IFRS Practice Statement

The main objective of the IFRS Practice Statement, *Management Commentary* is that the IASB can **improve the quality of financial reports** by providing guidance "for all jurisdictions, in order to promote comparability across entities that present management commentary and to improve entities' communications with their stakeholders". In preparing this guidance, the IASB team has reviewed existing requirements around the world, such as the Operating and Financial Review in the UK (now replaced by the Strategic Report), Management's Discussion and Analysis (MD&A) in the US and Canada, and the German accounting standard on Management Reporting.

9.3 Scope

The IASB has published a Practice Statement rather than an IFRS on management commentary. This 'provides a broad, non-binding framework for the presentation of management commentary that relates to financial statements that have been prepared in accordance with IFRS Standards'.

This guidance is designed for publicly traded entities, but it would be left to regulators to decide who would be required to publish management commentary.

This approach avoids the adoption hurdle ie, that the perceived cost of applying IFRS Standards might increase, which could otherwise dissuade jurisdictions/countries not having adopted IFRS Standards from requiring their adoption, especially where requirements differ significantly from existing national requirements.

9.4 Definition of a management commentary

The following preliminary definition is given in the Practice Statement:

Definition

Management commentary: A **narrative report** that provides a context within which to interpret the financial position, financial performance and cash flows of an entity. It also provides management with an opportunity to explain **its objectives and its strategies** for achieving those objectives. (IFRS Practice Statement)

9.5 Principles for the preparation of a management commentary

When a management commentary relates to financial statements, then those financial statements should either be provided with the commentary or the commentary should clearly identify the financial statements to which it relates. The management commentary must be clearly distinguished from other information and must state to what extent it has followed the Practice Statement.

Management commentary should follow these principles:

(a) To provide **management's view** of the entity's performance, position and progress

(b) To **supplement and complement** information presented in the financial statements

(c) To include **forward-looking information**

(d) To include information that possesses the **qualitative characteristics** described in the *Conceptual Framework*

9.6 Elements of a management commentary

The Practice Statement says that to meet the objective of management commentary, an entity should include information that is essential to an understanding of the following:

(a) The **nature of the business**

(b) Management's **objectives and its strategies** for meeting those objectives

(c) The entity's most significant **resources, risks and relationships**

(d) The **results** of operations and **prospects**

(e) The critical **performance measures and indicators** that management uses to evaluate the entity's performance against stated objectives

The Practice Statement does not propose a fixed format, as the nature of management commentary would vary between entities. It does not provide application guidance or illustrative examples, as this could be interpreted as a floor or ceiling for disclosures. Instead, the IASB anticipates that other parties will produce guidance.

However, the IASB has provided a table relating the five elements listed above to its assessments of the needs of the primary users of a management commentary (existing and potential investors, lenders and creditors).

Element	User needs
Nature of the business	The knowledge of the business in which an entity is engaged and the external environment in which it operates.
Objectives and strategies	To assess the strategies adopted by the entity and the likelihood that those strategies will be successful in meeting management's stated objectives.
Resources, risks and relationships	A basis for determining the resources available to the entity as well as obligations to transfer resources to others; the ability of the entity to generate long-term sustainable net inflows of resources; and the risks to which those resource-generating activities are exposed, both in the near term and in the long term.
Results and prospects	The ability to understand whether an entity has delivered results in line with expectations and, implicitly, how well management has understood the entity's market, executed its strategy and managed the entity's resources, risks and relationships.
Performance measures and indicators	The ability to focus on the critical performance measures and indicators that management uses to assess and manage the entity's performance against stated objectives and strategies.

9.7 Advantages and disadvantages of a compulsory management commentary

Advantages	Disadvantages
Entity • Promotes the entity, and attracts investors, lenders, customers and suppliers • Communicates management plans and outlook	Entity • Costs may outweigh benefits • Risk that investors may ignore the financial statements
Users • Financial statements not enough to make decisions (financial information only) • Financial statements backward looking (need forward-looking information) • Highlights risks • Useful for comparability to other entities	Users • Subjective • Not normally audited • Could encourage companies to de-list (to avoid requirement to produce MC) • Different countries have different needs

The IASB is working to update and improve the Management Commentary, and an Exposure Draft is expected in due course. Refer to Corporate Laws and Practices workbook of Professional level for the regulatory requirements for listed companies on financial and operational review as part of management commentary/Director's and Chairman's report.

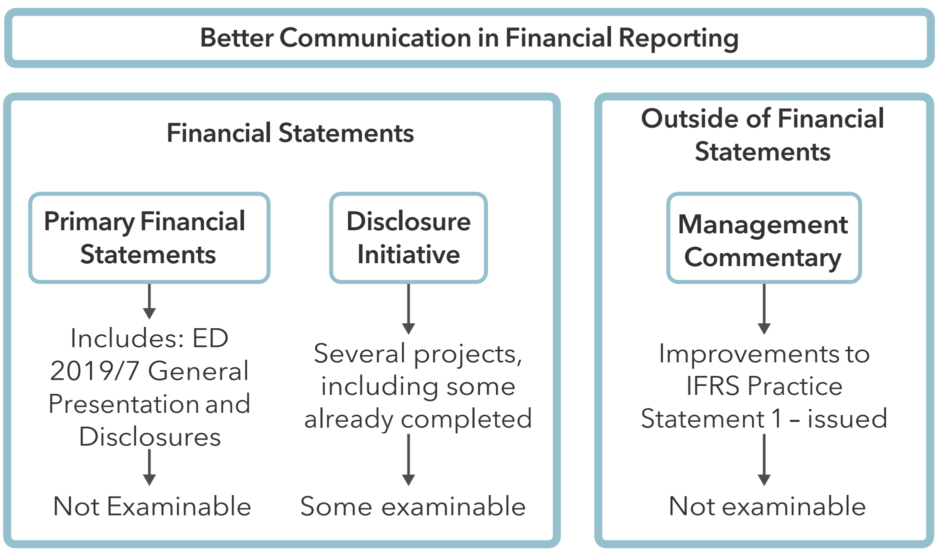
Professional skills focus: Applying judgement

There is generally more subjectivity and exercise of judgement in preparing a management commentary or strategic report than there is when preparing financial statements, which have over the years considerably narrowed the choices available.

9.8.1 Better Communication in Financial Reporting

Since 2015, a major theme of the IASB's work has been to improve communication in financial reporting. This is in response to feedback from users of financial statements that financial statements can be poorly presented, making it time-consuming and difficult for users to identify useful information.

The IASB has grouped together several projects under the heading 'Better Communication in Financial Reporting'.



10 Summary

Section overview

This section provides a summary of the areas covered so far in this chapter.

Financial statements can help analysts in evaluating a company's activities by:

- providing disclosures about a firm's current financial position and historical performance;
- providing information from which financial models can be constructed to forecast future performance and position; and
- helping to evaluate the value creation potential of financial decisions using valuation models.

While financial statements may have other uses for other users, for the analyst the key link is that between financial statements and the valuation process. This is not to suggest that financial statements provide a valuation. Rather, they are an input, along with other sources of information, into valuation models.

This chapter has attempted to provide a methodology for how the raw financial reporting information contained in the financial statements of a company can be interpreted, adjusted and standardised and then used for analysis, decision-making, forecasting and valuation. In this way the information will help with the assessment of the impact on value of key operating, investment and financing decisions.

The chapter considered how weaknesses of financial reporting information, such as weaknesses inherent in accounting practice, as well as any 'creativity' by management, can distort the usefulness of such information. Any forecasting or valuation model, no matter how sophisticated, is likely to be of little worth if it uses inappropriate information. The quality of earnings and of other accounting information was thus considered in order to normalise earnings as a prerequisite for any consistent forecasting of sustainable earnings and valuation modelling.

Accounting ratios then considered how the adjusted figures could be interpreted by examining ratios and other relationships against predetermined benchmarks to highlight unusual features and changes. This analysis helps us understand the current financial position and historical performance of the company. Also, however, to the extent that the relationships represented by ratios are sustainable over time, they can be built into valuation models in order to predict the consequences of changing one variable for other variables.

Forecasts of future earnings were examined based on adjusted financial information. In this context, forecasting depends on many sources of information, of which financial statements are only one. For financial statements to be useful, however, it is necessary to:

- understand their integrated nature;
- recognise how separate components interact; and
- comprehend the many pages of detailed supporting information presented in an annual report.

Moreover, it is necessary to understand the strategic and behavioural context within which financial reporting is taking place, in order to forecast future performance on the basis of financial reporting information.

Some of the defects of financial statement analysis have been addressed in the IASB's *Management Commentary*.

Professional skills focus: Assimilating and using information

In an exam scenario, you may be faced with information from the *Management Commentary* that someone at the client has drawn your attention to. While this information will be useful, it is important to consider the potential for subjectivity in the Management Commentary, and to use this information wisely, placing more emphasis on information assimilated from elsewhere in the question, such as the financial statements themselves, perhaps drilling down.

11 Audit focus on fraud

Section overview

- It is important for auditors to understand their responsibilities for detecting fraud and plan their audit to maximise the chance of detection and ultimately control audit risk.

- In this section we will look at the following:
  - An introduction as to why fraud is a difficult area for both business and auditor
  - What fraud means
  - The types of fraud that a business can suffer
  - The types of risk factor that the auditor should look out for when planning an audit
  - How the auditor should then address the risk of fraud occurring
  - How fraud should be reported, if at all
  - The ongoing debate of the expectation gap and the role of the auditor in the detection of fraud

11.1 Introduction

In section 3 above, we looked at the manipulation of information in the financial statements by creative accounting, and some of the 'red flags' that may indicate creative accounting practice.

Creative accounting can be one form of fraudulent financial reporting. While some creative accounting practices are clearly fraudulent, others are, strictly, allowable, but nevertheless show a less than ethical attitude on the part of the company directors.

In this section, we will look at the auditor's responsibilities in respect of not just creative accounting, but fraud in general. This is the scope which has been adopted by the ISAs.

The Global Economic Crime and Fraud Survey by PwC has monitored levels of fraud for over 20 years: in 2020, it reported that 47% of its 5,000+ respondents had experienced fraud in the last 24 months, the second highest reported level of incidents since the survey was first conducted, with estimated losses during this period estimated to be $42 billion. The top five areas of fraud were:

- Customer fraud
- Cybercrime
- Asset misappropriation
- Bribery and corruption
- Accounting/financial statement fraud

Given these alarming findings, the survey concludes that more can and should be done to address the causes of fraud, observing that only half of organisations are dedicating resources to risk assessment, governance and third party management in this area.

(Source: PwC (2020) Fighting fraud: A never-ending battle [Online]. Available at: https://www.pwc.com/gx/en/forensics/gecs-2020/pdf/global-economic-crime-and-fraud-survey- 2020.pdf [Accessed 7 October 2022])

11.2 What is fraud?

ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* provides guidance for the auditor. ISA 240 provides the following definitions.

Definitions

Fraud: An intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage.

Fraud risk factors: Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud. (ISA 240.12)

Fraud may be perpetrated by an individual, or colluded in with people internal or external to the business. It is a contributing factor to business risk.

It is the fact that fraud is a form of deceit that makes its prevention and detection difficult for both business and the auditor. The perpetrator of the fraud does not want to be detected and will go out of their way to be successful. **Fraud should be distinguished from error** where the latter arises from a **genuine mistake** with no intention to deceive. The deliberate nature of fraud creates a higher risk of misstatement which the auditor needs to factor into the audit approach. (ISA 240.6)

While management may be concerned with different levels of fraud, it is only fraud that results in a material misstatement in the financial statements that is of concern to the auditor.

Specifically, there are two types of fraud causing material misstatement in financial statements:

(a) **Fraudulent financial reporting**

(b) **Misappropriation of assets**

11.3 Fraudulent financial reporting

This fraud has a **direct impact on the financial statements** and will arise from any of the following:

- Manipulation, falsification (including forgery) or alteration of accounting records/supporting documents from which the financial statements are prepared
- Misrepresentation (or intentional omission) of events, transactions or other significant information in the financial statements
- Intentional misapplication of accounting principles (ISA 240.A3)

Such fraud may be carried out by overriding controls that would otherwise appear to be operating effectively, for example by recording fictitious journal entries or improperly adjusting assumptions or estimates used in financial reporting.

You will recall in the Parmalat example in Chapter 6 that the scenario also raises the question as to whether auditors can simply rely on bank confirmations when they relate to substantial sums of assets. Do these confirmations constitute sufficient and appropriate audit evidence?

11.3.1 Aggressive earnings management

Aggressive earnings management is an example of **creative accounting**. It occurs when management alters the financial statements in order to mislead stakeholders about the financial position or performance of the business or to influence the outcome of contracts. It usually involves the artificial enhancement of revenue and profit. Businesses are likely to be at risk of this when:

(a) there has been an adverse market reaction and so management may want to present a healthier picture about the company than is in fact the case;

(b) management bonuses are tied into targets and there may be a personal conflict between what management want for themselves and what is good for the company;

(c) the business wants to reduce its tax liabilities and in this case profits may be deliberately reduced; or

(d) the business needs to remain within certain financial parameters (limits, ratios) in order to achieve new funding or so as not to be in breach of loan covenants. Profit overstatement could be an issue, as well as understatement of liabilities and overstatement of assets.

Auditors should be on the alert for issues such as unsuitable revenue recognition, unnecessary accruals, reduced liabilities, overstatement of provisions, reserves accounting and large numbers of immaterial breaches of financial reporting requirements to see whether together, they constitute fraud.

11.4 Misappropriation of assets

This is the theft of the entity's assets (for example, cash, inventory). Employees may be involved in such fraud in small and immaterial amounts; however, it can also be carried out by management for larger items who may then conceal the misappropriation, for example by:

- Embezzling receipts (for example, diverting them to private bank accounts)
- Stealing physical assets or intellectual property (inventory, selling data)
- Causing an entity to pay for goods not received (payments to fictitious vendors)
- Using assets for personal use

(ISA 240.A5)

11.5 Responsibilities with regard to fraud

The business

Management and those charged with governance in an entity are primarily responsible for **preventing and detecting fraud**. It is up to them to put a strong emphasis within the company on fraud prevention. We have already covered the principles of this in Chapter 3.

The auditor

Auditors are responsible for carrying out an audit **in accordance with international auditing standards**.

11.6 The auditor's approach to the possibility of fraud

11.6.1 General

The objectives of the auditor in this area are set out early in ISA 240.11:

(a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement due to fraud, including:

   (1) identifying and assessing the risks of material misstatement of the financial statements due to fraud;

   (2) obtaining sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and

(b) To respond appropriately to fraud or suspected fraud identified during the audit.

An overriding requirement of the ISA is that auditors are aware of the possibility of there being misstatements due to fraud.

As we have seen in Chapter 6, the auditor shall maintain an attitude of **professional scepticism** throughout the audit. He/she must recognise the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of management and those charged with governance.

This requires that the auditor continue to question the sufficiency and appropriateness of the evidence collected during the audit. Threats to auditor independence could impact on the auditor's ability to maintain such scepticism.

Members of the engagement team should discuss the susceptibility of the entity's financial statements to material misstatements due to fraud.

Interactive question 4: The possibility of fraud

You are an audit partner of Dupi Ltd. The company operates a chain of sandwich bars throughout the south of England. The company is owned by three directors. At your last meeting with the client, you were informed that the company was hoping to expand and open up some shops in the north of England. The directors had not yet formalised the strategy for the expansion or its financing.

You have received the following letter:

"I have been an employee of this company for a number of years. Unfortunately, I have come across some information which I am not sure what to do about. There have been a number of journals relating to revenue for which I have not been able to obtain an explanation. The effect of these journals is to increase revenue substantially. Not sure if this is relevant to you."

The planning meeting with the audit team for this year's audit is scheduled for next week.

Requirement

What are the issues that you would raise at the planning meeting? See **Answer** at the end of this chapter.

11.6.2 Accountancy Sector Fraud Charter

During 2021, the UK government published a charter that explains how it will work with the accountancy profession in order to reduce the fraud risks that accountants (and by association, society in general) may be exposed to. In absence of any such charter in Bangladesh, we can look into the vulnerabilities and probable actions to deal with fraudulent actions.

The charter is structured around four main actions that are designed to address vulnerabilities that fraudsters may attempt to exploit:

Vulnerabilities that could be exploited	Actions to tackle fraud in the accountancy sector
The transparency of fraud threats across the accountancy sector is inadequate for suitable action to be taken.	A government-led joint initiative between law enforcement bodies and the accountancy sector will help to educate practitioners more effectively about relevant fraud threats.
Across the accountancy sector, the threats presented by fraud are not always able to be countered by sufficient resources and training.	A toolkit of training, red-flags and other useful information will be created by the accountancy profession which is accessible to all accountants.
Fraudsters use their association with accountants and information recorded within Companies House as a way of legitimising their operations.	Greater collaboration between government, accountants and Companies House, which will improve the reliability of this information.
A lack of awareness of fraud risks among clients and the general public has meant that fraud goes unnoticed.	Multi-stakeholder approach, including the accountancy profession, to share information and improve levels of fraud awareness and education.

Source: Fraud Sector Charter: Accountancy, UK Government, published 21 October 2021 [Online]. Available at: https://www.gov.uk/government/publications/joint-fraud-taskforce-accountancy-charter [Accessed 7 October 2022].

11.7 Risk assessment procedures

As discussed in Chapter 5, the auditor will undertake **risk assessment procedures** as set out in ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement* which will include assessing the risk of fraud. These procedures will include the following:

- Inquiries of management and those charged with governance (eg, as to whether there have been any incidences of fraud, the nature of the fraud and the outcome)
- Consideration of when fraud risk factors are present (some businesses are more susceptible to fraudulent activity than others eg, poor control environment, cash-based business, dominant senior management, poor staff relations, need for more finance, increased competition, poor market performance)
- Consideration of results of analytical procedures (eg, any unusual fluctuations in business year-on- year ratios and also those compared to industry norm)
- Consideration of any other relevant information (eg, press reports)

In identifying the risks of fraud, the auditor is required by the ISA to carry out some specific procedures.

The auditor must:

- make inquiries of management regarding their assessment of the risk and their processes for identifying and responding to the risks of fraud;
- make inquiries of management, those charged with governance and others within the entity (and the internal audit function where there is one), to determine whether they have knowledge of any actual, suspected or alleged fraud;
- obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud;
- consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud; and
- evaluate whether the information obtained from other risk assessment procedures and related activities indicates fraud risk factors exist. (ISA 240.17–.24)

Interactive question 5: Finding out about suspected fraud

Following on from Dupi Ltd (Interactive question 4), outline the information that the auditor would seek from the client.

See **Answer** at the end of this chapter.

11.8 Examples of fraud risk factors

Appendix 1 to ISA 240 provides further analysis of the two types of fraud depending on the conditions that exist in the client's business community:

- **Incentives/pressures**
- **Opportunities**
- **Attitudes/rationalisations**

The following diagrams illustrate some of the key areas of each category: Figure 24.1: Fraud risk factors

Fraudulent financial reporting

Incentives/pressures

- Financial stability/ profitability is threatened
- Pressure for management to meet the expectations of third parties
- Personal financial situation of management threatened by the entity's financial performance
- Excessive pressure on management or operating personnel to meet financial targets

Opportunities

- Significant related-party transactions
- Assets, liabilities, revenues or expenses based on significant estimates
- Domination of management by a single person or small group
- Complex or unstable organisational structure
- Internal control components are deficient

Attitudes/rationalisations

- Ineffective communication or enforcement of the entity's values or ethical standards by management
- Known history of violations of securities laws or other laws and regulations
- A practice by management of committing to achieve aggressive or unrealistic forecasts
- Low morale among senior management
- Relationship between management and the current or predecessor auditor is strained

Misappropriation of assets

Incentives/pressures

- Personal financial obligations
- Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft

Opportunities

- Large amounts of cash on hand or processed
- Inventory items that are small in size, of high value, or in high demand
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips Inadequate internal control over assets

Attitudes/rationalisations

- Overriding existing controls
- Failing to correct known internal control deficiencies
- Behaviour indicating displeasure or dissatisfaction with the entity
- Changes in behaviour or lifestyle

In addition, remember that some specific 'red flags' indicating creative accounting are set out in section 3.

When identifying and assessing the risks of material misstatement at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures, the auditor must identify and assess the risks of material misstatement due to fraud. Those assessed risks that could result in a material misstatement due to fraud are significant risks and accordingly, to the extent not already done so, the auditor must obtain an understanding of the entity's related controls, including control activities relevant to such risks (ISA 240.27).

The auditor:

- identifies fraud risks;
- relates this to what could go wrong at a financial statement level; and
- considers the likely magnitude of potential misstatement.

Note: When identifying and assessing fraud risk there is a presumption that there are risks of fraud in revenue recognition. (ISA 240.27)

Interactive question 6: Sellfones

You are an audit manager for Elle and Emm. You are carrying out the planning of the audit of Sellfones plc, a high street retailer of mobile phones in the UK, for the year ending 30 September 20X7. The notes from your planning meeting with Pami Desai, the financial director, include the following:

(1) One of Sellfones's main competitors ceased trading during the year due to the increasing pressure on margins in the industry and competition from online retailers.

(2) A new management structure has been implemented, with 10 new divisional managers appointed during the year. The high street shops have been allocated to these managers, with approximately 20 branch managers reporting to each divisional manager. The divisional managers have been set challenging financial targets for their areas with substantial bonuses offered to incentivise them to meet the targets. The board of directors have also decided to cut the amount that will be paid to shop staff as a Christmas bonus.

(3) In response to recommendations in the prior year's Report to Management, a new inventory system has been implemented. There were some teething problems in its first months of operation but a report has been submitted to the board by Steven MacLennan, the chief accountant, confirming that the problems have all been resolved and that information produced by the system will be accurate. Pami commented that the chief accountant has had to work very long hours to deal with this new system, often working at weekends and even refusing to take any leave until the system was running properly.

(4) The company is planning to raise new capital through a share issue after the year end in order to finance expansion of the business into other countries in Europe. As a result, Pami has requested that the auditor's report is signed off by 15 December 20X7 (six weeks earlier than in previous years).

(5) The latest board summary of results includes:

	9 Months to 30 June 20X7 (unaudited)		**Year to 30 September 20X6 (audited)**
	£m		**£m**
Revenue	320	Revenue	280
Cost of sales	215	Cost of sales	199
Gross profit	105	Gross profit	81
Operating expenses	(89)	Operating expenses	(70)
Exceptional profit on			
sale of properties	30		
Profit before tax	46		11

(6) Several shop properties owned by the company were sold under sale and leaseback arrangements.

Requirements

6.1 Identify and explain any fraud risk factors that the audit team should consider when planning the audit of Sellfones plc.

6.2 Link the fraud risk to what could go wrong in the financial statements of Sellfones.

See **Answer** at the end of this chapter.

11.9 Responding to assessed risks

Having identified risk factors, the auditor must then come up with responses to the assessed risks. The auditor needs to assess if the fraud potentially has a material impact on the financial statements and how best to address it. In particular the auditor must:

- ensure that personnel with the required skill and ability are assigned to the audit;
- test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements;
- review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of fraud; and
- evaluate for significant transactions that are outside the normal course of business whether the business rationale (or lack of) suggests fraudulent financial reporting or misappropriation of assets.

Interactive question 7: Specific audit procedures

Following on from Interactive questions 4 and 5, outline the steps that the auditor should now integrate into the audit procedures for Dupi Ltd.

See **Answer** at the end of this chapter.

11.10 Evaluation of audit evidence

The auditor evaluates the audit evidence obtained to ensure it is consistent and that it achieves its aim of answering the risks of fraud. This will include a consideration of results of **analytical procedures** and other misstatements found. The auditor must also consider the **reliability of written representations by management**.

The auditor must obtain written representation that management accepts its responsibility for the prevention and detection of fraud and has made all relevant disclosures to the auditors.

(ISA 240.40)

11.11 Documentation

The auditor must document the following:

- The significant decisions as a result of the team's discussion of fraud
- The identified and assessed risks of material misstatement due to fraud
- The overall responses to assessed risks
- Results of specific audit tests
- Any communications with management

(ISA 240.45–.48)

11.12 Reporting

There are various reporting requirements in ISA 240.

If the auditor has identified a fraud or has obtained information that indicates a fraud may exist, the auditor must communicate these matters as soon as practicable (unless prohibited by law or regulation) to the **appropriate level of management**.

If the auditor has identified fraud involving:

(a) management;

(b) employees who have significant roles in internal control; or

(c) others, where the fraud results in a **material misstatement** in the financial statements,

then the auditor must communicate these matters to those charged with governance as soon as practicable. (ISA 240.41-.43)

The auditor should also make relevant parties within the entity aware of **significant deficiencies** in the design or implementation of controls to prevent and detect fraud which have come to the auditor's attention, and consider whether there are any other relevant matters to bring to the attention of those charged with governance with regard to fraud. The ISA does explain that such communication should not be made if prohibited by law or regulation: as an example of this, should this communication be considered tipping-off, the auditor should take alternative action.

The auditor may have a statutory duty to report fraudulent behaviour to regulators outside the entity. For example, in the UK, anti-money laundering legislation imposes a duty on auditors to report suspected money laundering activity. Suspicions relating to fraud are likely to be required to be reported under this legislation. If no such legal duty arises, the auditor must consider whether to do so would breach their professional duty of confidence. In either event, the auditor should take **legal advice**.

Professional skills focus: Concluding, recommending and communicating

A situation where fraud is suspected will test the auditor's communication skills considerably. All communication on the subject must be clear and neutral in tone.

11.12.1 PIEs

For audits of the financial statements of PIEs, when the auditor suspects fraud the auditor must inform the entity (unless prohibited by law or regulation) and invite it to investigate. If the entity does not investigate the matter the auditor must inform the relevant authorities.

(ISA 240.41-43)

11.13 Withdrawal from the engagement

The auditor should consider the need to withdraw from the engagement if the auditor uncovers exceptional circumstances with regard to fraud. (ISA 240.39)

Context example: Auditor resignation

KPMG Switzerland has resigned as auditor of FIFA after more than a decade vetting the accounts of football's scandal-hit governing body.

The announcement comes amid one of the most serious corruption investigations facing FIFA and weeks after **the resignation of its finance director Markus Kattner** following an internal probe that found he had received millions in bonus payments.

In a statement, FIFA said it "welcomed this change as it gives the organisation the opportunity to work with a new audit firm". FIFA president Gianni Infantino has initiated a comprehensive financial audit of FIFA's finance function including its processes and procedures. It plans to appoint a new auditor, a new chief financial officer and a new chief compliance officer. "In light of the serious allegations involving financial transactions outlined by the Swiss and US authorities, it is essential that the financial function at FIFA be externally reviewed and thoroughly reformed." FIFA said.

KPMG has already **launched an internal probe into its Swiss arm's audits of FIFA**, while FA chairman Greg Dyke last year questioned KPMG's role in FIFA's corruption scandal. Last month, **FIFA's audit chairman Domenico Scala quit the governing body** after it passed a resolution which he claimed undermined the independence of its watchdog committees.

(Source: *Accountancy Age*, 2016)

Remember that in Bangladesh the auditor has the **right to resign** from office at any time. This is a way of preserving independence and integrity as well as a way of addressing threats to independence.

11.14 The expectation gap

As we have seen, fraud is a sensitive issue. When it happens, the question that is always asked is 'who's to blame?' The answer can only be one of two: management or the auditor? Management's responsibilities for prevention and detection of fraud are set out in governance and the auditor's in ISA 240, but the public are still not clear about the division of responsibility. The expectation gap arises from a difference in opinion as to what the public perceive the role of the auditor to be and what the auditor actually does.

There continues to be much discussion as to what could be done to narrow this gap, with the auditing profession taking the lead. This is being done with a view to protecting its members.

11.14.1 Narrowing the expectation gap

The expectation gap could, theoretically, be narrowed in two ways.

Educating users

The auditor's report as outlined in ISA 700 (revised) includes an explanation of the auditor's responsibilities including that relating to fraud. A further suggestion is that auditors could highlight circumstances where they have had to rely on directors' representations.

Suggestions for expanding the auditor's role have included the following:

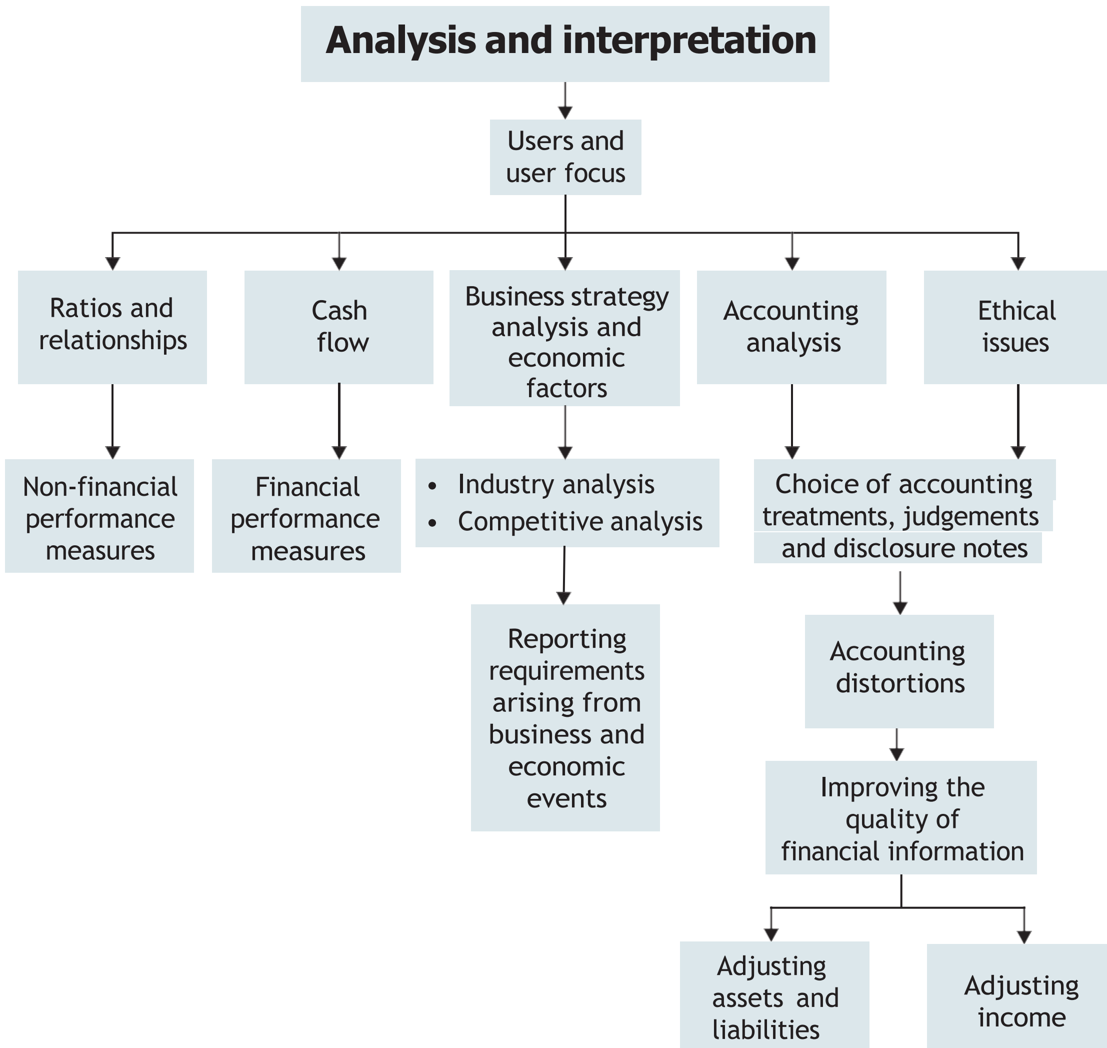
- Requiring auditors to report to boards and audit committees on the adequacy of controls to prevent and detect fraud (For statutory audits of PIEs the auditor is required to report in the additional report to the audit committee any significant matters involving actual or suspected non-compliance with laws and regulations including those related to fraud. (ISA 240.A66)
- Encouraging the use of targeted forensic fraud reviews
- Increasing the requirement to report suspected frauds

Extending the auditor's responsibilities

Research indicates that extra work by auditors with the inevitable extra costs is likely to make little difference to the detection of fraud because:

- most material frauds involve management;
- more than half of frauds involve misstated financial reporting but do not include diversion of funds from the company;
- management fraud is unlikely to be found in a financial statement audit; and
- far more is spent on investigating and prosecuting fraud in a company than on its audit.

Summary



Analysis and interpretation
Users and user focus
Ratios and relationships
Cash flow
Business strategy analysis and economic factors
Accounting analysis
Ethical issues
Non-financial performance measures
Financial performance measures
• Industry analysis
• Competitive analysis
Choice of accounting treatments, judgements and disclosure notes
Reporting requirements arising from business and economic events
Accounting distortions
Improving the quality of financial information
Adjusting assets and liabilities
Adjusting income

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	What is the scope of accounting analysis? (Topic 3)
2.	Can you define 'creative accounting'? (Topic 3)
3.	What form do accounting distortions take? How did the recent standard IFRS 16 eliminate a potential accounting distortion? (Topic 4)
4.	How can financial statements be made more comparable? (Topic 5)
5.	Can you explain the purpose of the Management Commentary? (Topic 9)
6.	What are the auditors' responsibilities in respect of fraud? (Topic 11)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Digicom	In keeping with the broader types of financial analysis covered in this chapter, this question goes into more depth about the industry in which the company operates.
CD Sales	This question deals with ethical issues in relation to the financial reporting treatment of certain transactions, and the issue of fraud.
Mackie	The focus on fraud continues with this question which requires a discussion of responsibility for preventing and detecting fraud and the auditors' responsibility in relation to fraud.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios to help you improve knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Kenyon	The analysis in this question is from the point of view of the potential investor. As well as ratio analysis, there is a separate issue of the impact of a contingent liability.
Precision Garage Access	Financial analysis often arises in an audit context. In this question some inadequate analytical procedures have been performed and you are required to produce revised, improved analytical procedures.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving on to the next chapter.

Drakoulakos, P. (2019) *Sale and Leaseback Transactions and IFRS 16 Implications.* [Online]. Available from http://www.moore-global.com/insights/articles/sale-and-leaseback-transactions-and-ifrs-16- implic [Accessed 7 October 2022].

1 ISA 240

- Auditor's objectives relating to fraud – **ISA 240.10**
- Assess risk of material misstatement – **ISA 240.16–.27**
- Responding to assessed risks – **ISA 240.28–.33**
- Reporting fraud – **ISA 240.40–.43-1**

2 ISA 315

- Risk assessment procedures – **ISA 315.13–.18**

Self-test questions

Answer the following questions

1 Digicom Distributors Ltd

You are Paula Jones, a manager of John Mills and Co. Your client, Digicom Distributors Ltd, has for several years been a family-owned company selling telephones and answering machines through its own dealer network in the south of England. In May 20X0 the company was bought by two brothers, Peter and Charles Brown.

Shortly thereafter the company acquired the exclusive UK distribution rights to a revolutionary new video mobile phone, manufactured in South Korea, which sells for about half the price of competitive products and is fully compatible with all British mobile telephone networks.

During the year ended 31 August 20X1 expansion has been rapid under the new

management. The following points should be noted.

(1) The distribution rights for the South Korean phone cost £850,000. The rights were acquired for a period of 10 years, and the directors of Digicom Distributors Ltd decided to capitalise the initial cost and amortise it over the 10-year period on a straight-line basis. The current carrying amount is £744,000. The new phone received extensive media acclaim during October and November 20X0, accompanied by regional television advertising campaigns. Since then monthly sales have increased from £500,000 to £1,600,000.

(2) The advertising campaign cost the company £1,000,000. The directors believe that it will have long-term benefits for the sales of the phone and, consequently, they decided to capitalise the advertising cost and amortise it over the same period as the distribution rights. The current carrying amount for the advertising expenditure is £925,000.

(3) Sales of the new phone now account for 75% of the company's revenue. The level of credit sales has remained constant at 30% of total sales.

(4) The company has purchased dealer networks from three other companies and is negotiating to purchase two more, which will then complete its national coverage.

(5) Employee numbers have increased rapidly from 40 to 130. This includes administration staff at head office, where numbers have risen from 12 to 28.

(6) In June 20X1 the central distribution and servicing department moved from head office into larger premises in Milton Keynes. The total cost of the relocation was £625,000, which has been included in administrative expenses.

The move was necessary to handle not only the increased inventory and pre-delivery checks, but also the rising level of after-sales warranty work caused by manufacturing defects in the new phone.

The company has maintained its warranty policy of providing for 1% of revenue each year. The movements in the warranty provision for the current year are as follows.

	£'000
At 31 August 20X0	262
Provision for year	160
Provision used	(94)
At 31 August 20X1	328

Draft accounts of Digicom Distributors Ltd as at 31 August 20X1 were as follows:

Statement of profit or loss and other comprehensive income for the year ended 31 August 20X1

	20X1 £'000	20X0 £'000
Revenue	16,000	5,200
Cost of sales	(12,400)	(4,264)
Gross profit	3,600	936
Distribution costs	(837)	(425)
Administrative expenses	(2,253)	(609)
Operating profit/(loss)	510	(98)
Finance costs	(320)	(35)
Profit/(loss) before tax	190	(133)
Tax on profit or loss	(15)	(10)
Profit/(loss) for the period	175	(143)
Other comprehensive income		
Revaluation surplus	400	
Total comprehensive income	575	(143)

Statement of financial position as at 31 August 20X1

		20X1		20X0
	£'000	£'000	£'000	£'000
Non-current assets				
Intangible assets		1,669		829
Property, plant and equipment		6,623		2,564
		8,292		3,393
Current assets				
Inventories	778		520	
Receivables	814		215	
Cash and cash equivalents	250		400	
	1,842		1,135	
Current liabilities				
Bank overdrafts	975		150	
Trade payables	2,734		678	
	3,709		828	
Net current assets/(liabilities)		(1,867)		307
Total assets less current liabilities		6,425		3,700
Non-current liabilities				
Bank loan		(2,084)		–
Provisions		(328)		(262)
		4,013		3,438
Capital and reserves				
Share capital		100		100
Revaluation reserve		900		500
Retained earnings		3,013		2,838
		4,013		3,438

Requirement

Assess the profitability, liquidity and solvency of the company.

2 CD Sales plc

CD Sales plc, a listed company, was a growth-orientated company that was dominated by its managing director, Mr A Long. The company sold quality music systems direct to the public. A large number of salespersons were employed on a commission-only basis. The music systems were sent to the sales agents who then sold them direct to the public using telephone sales techniques. The music systems were supplied to the sales agents on a sale or return basis and CD Sales recognised the sale of the equipment when it was received by the sales agents. Any returns of the music systems were treated as repurchases in the period concerned.

The company enjoyed a tremendous growth record. The main reasons for this apparent expansion were as follows.

(1) Mr A Long falsified the sales records. He created several fictitious sales agents who were responsible for 25% of the company's revenue.

(2) At the year end, Mr Long despatched nearly all of his inventories of music systems to the sales agents and repurchased those that they wished to return after the year end.

(3) 20% of the cost of sales was capitalised. This was achieved by falsification of the purchase invoices with the co-operation of the supplier company. Suppliers furnished the company with invoices for non-current assets but supplied music systems.

(4) The directors of the company enjoyed a bonus plan linked to reported profits. Executives could earn bonuses ranging from 50% to 75% of their basic salaries. The directors did not query the unusually rapid growth of the company, and were unaware of the fraud perpetrated by Mr A Long.

Mr A Long spent large sums of money in creating false records and bribing accomplices in order to conceal the fraud from the auditor. He insisted that the auditor should sign a 'confidentiality' agreement which effectively precluded the auditor from corroborating sales with independent third parties, and from examining the service contracts of the directors. This agreement had the effect of preventing the auditor from discussing the affairs of the company with the sales agents.

The fraud was discovered when a disgruntled director wrote an anonymous letter to the stock exchange concerning the reasons for the CD Sales growth. The auditor was subsequently sued by a major bank that had granted a loan to CD Sales on the basis of interim financial statements. These financial statements had been reviewed by the auditor and a review report issued.

Requirements

2.1 Explain the key audit procedures which would normally ensure that such a fraud as that perpetrated by Mr A Long would be detected.

2.2 Discuss the implications of the signing of the 'confidentiality' agreement by the auditor.

2.3 Explain how the 'review report' issued by the auditor on the interim financial statements differs in terms of its level of assurance from the auditor's report on the year-end financial statements.

2.4 Discuss whether you feel that the auditor is guilty of professional negligence in not detecting the fraud.

3 Makie Ltd

You are the audit manager for the audit of Makie Ltd, a UK company operating in the manufacturing sector.

During the audit this year, the audit junior identified that the stores manager had been creating false purchases, creating suppliers on the purchase ledger with his own bank account details.

He had attempted to conceal the fraud by creating false orders, goods received notes and purchase invoices. The fraud was identified when this supplier was selected for creditor circularisation. It is apparent that this fraud took place over a period of at least three years.

The finance director estimates that the fraud has cost the company £500,000 which is material to the financial statements.

The MD is blaming the auditors for not detecting this fraud and is threatening to sue the firm for negligence.

Requirements

3.1 Draft a letter to the MD explaining the following:

- The responsibilities of directors and auditors relating to fraud
- The procedures required by professional standards in relation to fraud

3.2 Draft an email to the audit partner giving your opinion as to whether the firm is negligent.

4 Redbrick plc

Redbrick plc is a listed company operating in the civil engineering business generating an annual revenue of £350 million. Your firm has been the auditors of this company for many years.

The assignment partner received the following letter from the chair of the audit committee of Redbrick plc.

It has come to light that the MD and FD of one of our smaller subsidiaries, Tharn Ltd, have been engaging in fraudulent activities for some years. This has included use of Redbrick plc's assets on contracts for their own benefit. (They set up their own company particularly for this purpose.)

Also it looks as if there has been accounting manipulation that has caused profits and revenue to be recognised inappropriately thus enhancing the performance of Tharn Ltd, although there is no suggestion of misappropriation of assets in this case.

Quite frankly I am not sure why we have been paying you as auditors all these years when you cannot discover such obvious fraud as this appears to be. I do not expect a detailed evaluation of the matter at this stage but I would like some explanation of why this problem has not been discovered and reported by you.

The revenue of Tharn Ltd was £12 million in the last financial year. Tharn Ltd specialises in drainage construction, enhancement and clearance.

Requirement

As an audit senior, draft a response for the assignment partner to the letter from the chair of the audit committee of Redbrick plc.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

Industry revenues are expected to grow by 20% in 20X7 to reach £2,136 million. The market share of GeroCare has been stable at about 15% for the last five years. Assuming the market share remains the same in 20X7, the forecast revenues for GeroCare are £320 million (= 0.15 × £2,136m).

Answer to Interactive question 2

The asset turnover ratio defined as (Revenue ÷ Non-current assets) will produce a rough estimate of the assets required to produce the new level of sales. The factors that will affect the accuracy of this ratio are: (a) its stability over time (b) the mix between new capital expenditure for expansion and replacement and (c) the level of capital efficiency.

Answer to Interactive question 3

According to the clean surplus model, equity is determined solely by retained earnings. For 20X7 the predicted earnings are £27 million and dividend payments £8 million. Retained earnings therefore for 20X7 amount to £19 million and adding this amount to the value of equity at 31 December 20X6 yields the level of equity for 31 December 20X7, namely £69 million.

Answer to Interactive question 4

In this situation the issues that should be raised are as follows:

(1) The audit is likely to be higher risk than in previous years due to the receipt of the anonymous letter.

(2) The letter that has been received must be treated with the strictest confidence.

(3) There will need to be a thorough review of journal activity and any unusual ones should be brought to the attention of the audit manager for discussion with the client.

(4) Given that the company is hoping to expand, the team need to be made aware of the fact the company will be under pressure to present a strong financial performance and position in order to acquire the necessary finance.

(5) Incidences of management override of controls will need to be noted as they may indicate fraud.

Answer to Interactive question 5

Management may not be aware of the letter and so the auditor will have to proceed with caution (plus there may be money laundering implications, so 'tipping off' would be avoided if the auditor said nothing about the letter for now).

There will be some general queries that the auditor should make. These will need to be ascertained from the client management, internal audit and employees.

- How management identify and address fraud
- Whether or not they are aware of any incidences of fraud

- If so, what the fraudulent activity was and what impact, if any, it had on the financial statements. What controls, if any, have been implemented to address the deficiencies of the system

The auditor will also have to link the findings of the above inquiries to the anonymous letter to ascertain its validity.

The auditor should ask for draft accounts to review revenue for reasonableness. The reason for any unusual fluctuations should be discussed with management and validated. The auditor should also ascertain whether or not there have been any changes in accounting policy, as this may validate the journals.

The auditor should also ascertain whether there have been any changes in key personnel and the reasons behind the change. It may be possible that the person who wrote the letter was sacked by the company for querying the journal entries.

In addition, the auditor should ascertain the trading conditions of the client and identify any pressures that management may be under to misstate the financial statements.

(Check the following sections in ISA (UK) 240 (Revised) if you struggled to answer this question: ISA 240.17, ISA 240.32, ISA 240.A41–.A44.)

Answer to Interactive question 6

In this scenario there are a large number of factors that should alert the auditors to the possibility of misstatements arising from fraudulent financial reporting, and others that could indicate a risk of misstatements arising from misappropriation of assets.

(1) **Operating conditions within the industry**

The failure of a competitor in a highly competitive business sector highlights the threat to the survival of a business such as Sellfones and this could place the directors under pressure to overstate the performance and position of the company in an attempt to maintain investor confidence, particularly given the intention to raise new share capital.

Financial statement issue

This could mean that revenue may be overstated and costs understated. In addition, the appropriateness of going concern as a basis for the preparation of the financial statements will need to be questioned. This will be a particular issue if there is no alternative source of finance for the expansion. The shareholders may be unwilling to purchase more shares if the market is struggling.

(2) **Management structure and incentives**

It is not clear in the scenario how much involvement the new divisional managers have in the financial reporting process but the auditors would need to examine any reports prepared or reviewed by them very carefully, as their personal interest may lead them to overstate results in order to earn their bonuses.

Financial statement issue

Revenue may be overstated and bonuses may not be calculated correctly or properly accrued for.

(3) **New inventory system/chief accountant**

The problems with the implementation of the new inventory system suggest that there may have been control deficiencies and errors in the recording of inventory figures. Misstatements, whether deliberate or not, may not have been identified. The amount of time spent by the chief accountant on the implementation of the new inventory system could be seen as merely highlighting the severity of the problems, but the fact that he has not taken any leave should also be considered as suspicious and the auditors should be alert to any indication that he may have been involved in any deliberate misstatement of figures.

Financial statement issue

Inventory may not be correctly stated and this will impact on profit and current assets. In addition, inventory may not be appropriately valued, as net realisable value could be lower given the collapse of the main competitor and cheaper products being available on the internet.

(4) **Results**

The year on year results look better than might be expected given the business environment. The gross profit margin has increased to 32.8% (20X6 28.9%) and the operating profit margin has increased to 5% (20X6 3.9%). This seems to conflict with what is known about the industry and should increase the auditors' professional scepticism in planning the audit.

Financial statement issue

This links up with overstatement of revenue, understatement of costs, manipulation of the inventory figure and the incentive for the branch managers to misstate performance.

(5) **Exceptional gain**

The sale and leaseback transaction may involve complex considerations relating to its commercial substance. It may not be appropriate to recognise a gain or the gain may have been miscalculated.

Financial statement issue

The transaction may not have been correctly accounted for. For example IFRS 16 stipulates that the transfer must meet the performance criteria in IFRS 15 to be accounted for as a sale, otherwise the asset cannot be derecognised and a liability must be recognised for the 'sale' proceeds. This could mean that non-current assets and more importantly liabilities may be understated.

(6) **Time pressure on audit**

The auditors should be alert to the possibility that the tight deadline may have been set to reduce the amount of time the auditors have to gather evidence after the end of the reporting period and this may have been done in the hope that certain deliberate misstatements will not be discovered.

Financial statement issue

The pressure may lead to an increased chance of errors creeping into the financial statements.

(7) **Risk of misappropriation of assets**

The nature of the inventories held in the shops increases the risk that staff may steal goods. The risk is perhaps increased by the fact that the attitude of the staff towards their employer is likely to have been damaged by the cut in their Christmas bonus. The problems with the new inventory recording system increase the risk that any such discrepancies in inventory may not have been identified. A manual inventory count should be considered for the year end and a review of the results of any reconciliations between physical inventory and that recorded on the system will be important.

Financial statement issue

Once again, inventory may be misstated, especially if the new system is relied on.

Overall, this year's audit will be a high risk one given the changes to the business, the market conditions, the bonus issues for divisional managers and the potential lack of completeness and accuracy of the inventory records.

Answer to Interactive question 7

Having assessed the audit of Dupi Ltd as high risk, the following steps will now need to be taken.

(1) It is likely that staff who are familiar with the client and who have experience of high risk audits should be assigned to this audit.

(2) The letter states that revenue could be misstated and as a result further work on the relevance of the accounting policy and appropriateness of any changes will need to be carried out. The team should also look out for potential understatement of expenses. Cut-off will be a risky area and one that could easily be manipulated in order to overstate performance.

(3) The auditor should consider whether it is worth performing surprise visits. This may be of use when looking at the area of internal controls in the revenue cycle, especially where there are instances of management override. The auditor will need to focus on the results of any tests of control in the revenue cycle and the reasons behind any breakdown in the controls. The level of substantive testing may need to be increased as a result of lack of reliance on control procedures.

(4) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. Reasons for journal entries to revenue should be ascertained and corroborated with other audit evidence. It is unlikely that revenue can simply be overstated without impacting on other areas of the financial statements – are there any recoverability issues with receivables? This could indicate false sales.

(5) Detailed post year end work on cut-off and reversal of journal entries should be carried out to identify any window dressing transactions. Credit notes may have been issued after the year end to reverse out the revenue increase.

Finally, the auditor's knowledge of the client will also be a factor in determining the audit procedures for Dupi Ltd. The auditor will need to check whether or not there have been any issues with management integrity or incompetence in previous audits. This would indicate that a lesser degree of reliance can be placed on written representations by management and more reliance will be required from external third-party evidence.

Answers to Self-test questions

1 Digicom Distributors Ltd

Assessments Profitability

The company's gross profit margin is strengthening due to the South Korean phone, which can be purchased at very competitive prices and still be sold at half the price of competitive products. This can be further illustrated by comparing the 207% increase in revenue with a 285% increase in gross profit.

Similarly, overheads have only increased by 199%, even including one-off relocation expenses. Therefore, costs are being controlled despite the expansion, and the net margin is also strengthening. However, the overheads do not include all charges for advertising (see below). If these were included net profit would clearly fall. In addition, the company's warranty provisions do not appear to be calculated correctly and the expense is probably understated.

Return on capital employed has improved on the previous year, as the company has turned from a loss-making position to a profit. However, ROCE may be misleading, as there is some doubt as to the suitability of capitalising advertising expenditure and/or the cost of distribution rights. If these were charged as expenses, the company would continue to be in a loss-making position.

The improving profitability of the company is very reliant on the continued success of the South Korean phone and, in a rapidly changing industry, this cannot be guaranteed.

Liquidity

Liquidity has deteriorated in the period, as evidenced by both the current and quick ratios. The company has insufficient current assets from which to meet its current liabilities as they fall due.

This is coupled with very clear signs of overtrading, whereby the inventory turnover ratio has increased dramatically on the previous year. The company is holding very low levels of inventory compared to its increased levels of revenue, which may result in stock-outs and loss of goodwill. This low level of inventory appears to be caused by insufficient funds to finance the purchase of inventory. The company must raise further long-term finance if serious liquidity problems are to be avoided.

Solvency

The company is highly geared. Moreover, the gearing ratio in the appendix does not include the excessive overdraft included in current liabilities. Hence, actual gearing is even higher. Similarly, interest cover at 1.6 times is poor.

The company must raise more funds to survive, particularly if further expansion is to continue. However, lenders will see Digicom Distributors Ltd as a high risk investment and will therefore expect a high return.

Appendix: Accounting ratios

	Year ended 31 August	
	20X1	**20X0**
Profitability		
Return on capital employed		
= Operating profit ÷ (Total assets – Current liabilities)	510 ÷ 6,425 = 7.9%	(98) ÷ 3,700 = (2.6)%
Gross profit margin		
= Gross profit ÷ Revenue	3,600 ÷ 16,000 = 22.5%	936 ÷ 5,200 = 18.0%
Efficiency		
Asset turnover		
= Revenue ÷ (Total assets – Current liabilities)	16,000 ÷ 6,425 = 2.5 times	5,200 ÷ 3,700 = 1.4 times
Inventory turnover		
= Cost of sales ÷ Inventories	12,400 ÷ 778 = 15.9 times	4,264 ÷ 520 = 8.2 times
Receivables collection period		
= (Receivables ÷ Credit sales) × 365	(814 ÷ (16,000 × 30%)) × 365 = 62 days	(215 ÷ (5,200 × 30%)) × 365 = 50 days
Payables payment period		
= (Payables ÷ Cost of sales) × 365	(2,734 ÷ 12,400) × 365 = 80 days	(678 ÷ 4,264) × 365 = 50 days
Liquidity		
Current ratio		
= Current assets ÷ Current liabilities	1,842 ÷ 3,709 = 0.50	1,135 ÷ 828 = 1.37
Quick ratio		
= (Current assets – Inventory) ÷ Current liabilities	(1,842 – 778) ÷ 3,709 = 0.29	(1,135 – 520) ÷ 828 = 0.74
Solvency		
Debt/equity ratio		
= Long-term debt ÷ Capital and reserves	2,084 ÷ 4,013 = 0.52	
Interest cover		
= Operating profit ÷ Interest	510 ÷ 320 = 1.6	

2 CD Sales plc

2.1 There are various key audit procedures which would have uncovered the fraud perpetrated by Mr A Long. Note that the first two tests would bring to the attention of the auditor the substantial inherent and control risk surrounding the accounts of CD Sales, thus increasing the perceived audit risk, and putting them on their guard.

Analytical procedures

The auditor should perform analytical procedures in order to compare the company's results with those of other companies in the same business sector. In particular, the audit should look at sales growth rates and gross profit margins, but also inventory holding levels, non-current assets and return on capital. This should indicate that the company's results are unusual for the sector, to a great extent.

Review of service contracts

The auditor should examine the directors' service contracts. It is unusual for all directors to be paid such substantial bonuses, although the payment of bonuses of some sort to directors is common business practice. It is the size of the bonuses in proportion to the directors' base salaries which is the problem here. It increases both the inherent and control risk for the auditor because it reduces the directors' objectivity about the performance of the company. Audit risk is thus increased.

Testing of sales, purchases and inventories

(1) The main audit test to obtain audit evidence for sales would be to require direct confirmations from the sales agents. These confirmations would also provide evidence for the balance owed to CD Sales at the year end and the inventories held by the agent at the year end. Replies to such confirmations should be sent direct to the auditor who would agree the details therein to the company's records or reconcile any differences. Where replies are not received, alternative procedures would be carried out which might include visits to the agents themselves to examine their records.

(2) A selection of agents should, in any case, be visited at the year end to confirm the inventories held on sale or return by physical verification. The auditor should count such inventories and consider obsolescence, damage etc.

(3) Fictitious agents might be discovered by either of test (1) or (2), but a further specific procedure would be to check authorisation of and contracts with all sales agents. Correspondence could also be reviewed from throughout the year.

(4) The practice of 'selling' all the inventories to the agents and then repurchasing it after the year end should be detected by sales and purchases cut-off tests around the year end. All transactions involving inventory items returned after the year end should be examined.

Testing of non-current assets

Non-current asset testing should help to identify inventory purchases which have been invoiced as non-current assets.

(1) Samples of additions to non-current assets can be checked to the non-current asset register and to the asset itself.

(2) Physical verification will ensure that an asset is being used for the purposes specified, and this should be relatively straightforward to check as the assets will each have individual identification codes.

(3) Where the assets cannot be found, then it may be possible to trace the asset to inventories, perhaps via the selling agents' confirmation, or to sales already made.

Related parties

The level of collusion with suppliers makes detection of fraud difficult, but the auditor may be put on guard if he discovers that the suppliers are related parties to CD Sales. A related party review would normally take place as part of an audit.

2.2 The type of 'confidentiality agreement' signed by the auditor of CD Sales reduces the scope of the audit to such an extent that it has become almost meaningless.

While it is understandable that companies would wish to protect sensitive commercial information, the auditor has the right to any information he feels is necessary in the performance of his duties. This agreement clearly circumvents that right. Moreover, such information would still be protected if released to the auditor, because the auditor is under a duty of confidentiality to the client.

In reducing the scope of the audit to this extent, the agreement prevents the auditor obtaining sufficient appropriate evidence to support an audit opinion. The auditor's report should therefore be modified on the grounds of insufficient evidence, possibly to the extent of a full disclaimer.

In failing to issue such a modification, the auditor may well have acted negligently and even unlawfully in signing such an agreement.

2.3 A review of interim accounts is very different from an audit of year-end financial statements. In an auditor's report a positive assurance is given on the truth and fairness of the financial statements. The level of audit work will be commensurate with the level of assurance given; that is, it will be stringent, testing the systems producing the accounts and the year-end figures themselves using a variety of appropriate procedures.

In the case of a review of interim financial statements, the auditor gives only negative assurance, that he has not found any indication that the interim accounts are materially misstated. The level of audit work will be much less penetrating, varied and detailed than in a full audit. The main audit tools used to obtain evidence will be analytical procedures and direct inquiries of the company's directors.

2.4 It is not the duty of the auditor to prevent or detect fraud. The auditor should, however, conduct the audit in such a way as to expect to detect any material misstatements in the financial statements, whether caused by fraud or error. The auditor should undertake risk assessment procedures in order to assess the risk that fraud is occurring both at the financial statement and the assertion level and plan his procedures accordingly. Where fraud is suspected or likely, the auditor must carry out additional procedures in order to confirm or deny this suspicion.

Even if a fraud is uncovered after an audit, the auditor will have a defence against a negligence claim if it can be shown that auditing standards were followed and that no indication that a fraud was taking place was received at any time.

Application of principles

In this particular case, Mr A Long has taken a great deal of trouble to cover up his fraudulent activities, using accomplices, bribing people, cooking up fictitious documents etc. When such a high-level fraud is carried out, the auditor might find it extremely difficult to uncover the true situation or even realise anything was amiss. The auditor is also entitled to accept the truth of representations made to him and documents shown to him which purport to come from third parties.

On the other hand, the auditor should have a degree of professional scepticism. The auditor should be aware of the risks pertaining to actions. The suspicions of the auditor should have been aroused by the rapid growth rate of the company and fairly standard audit procedures on cut-off and non-current assets should have raised matters which required explanation.

Where the auditor has been most culpable, however, is in signing the confidentiality agreement. This restricted the scope of the audit to such an extent that the auditor should have known that there was insufficient evidence to support their opinion. The auditor will therefore find it difficult to defend a negligence claim.

3 Makie Ltd

3.1 To whom it may concern,

Fraud at Makie Ltd

I refer to the recently discovered fraud during the audit for this year. I appreciate your feelings on this subject and thought it might be helpful if I could summarise the auditors' and directors' responsibilities in this area.

In addition, as I am sure you are aware, auditors must follow professional standards and I thought you might find a summary of these rules useful.

Responsibility for fraud

The responsibility for preventing and detecting fraud lies with those charged with governance of Makie Ltd (the management). Fraud is normally prevented by implementing internal controls which should be regularly reviewed for robustness and errors by those charged with governance. The auditor considers the risk of material misstatement in the financial statements whether due to fraud or error, and adapts the audit procedures as necessary to reduce risk to an acceptably low level.

The auditor cannot be held responsible for the prevention of fraud under any circumstances. If a fraud is uncovered, the auditor will assess its materiality and may carry out additional tests. The detection of fraud is not the objective of the audit as stated in the engagement letter, so the auditor cannot be held responsible.

Professional standards

An auditor considers the risk of fraud and error in the financial statements, and aims for the financial statements to be free of material misstatements whether caused by fraud or error. If a fraud is detected, we are required to investigate the matter further. We managed to investigate in this case and revealed the full extent of the fraud, which was well concealed and complex.

We are also required to consider the risk of fraud when planning an audit as part of our risk assessment procedures, including understanding how management assess risk of fraud and the systems and controls they have put in place to detect and prevent it.

In addition, we consider whether any specific factors exist that may increase the risk of a fraud occurring and design the nature, timing and extent of our audit procedures to give us the best chance of detecting material fraud or errors.

We also consider that, regardless of management integrity in previous years, it is possible that a fraud could still be committed by management or senior staff.

Having said this, it can never be guaranteed that an audit will detect a fraud, and there is a chance that even material frauds will be missed, perhaps due to them not appearing in our samples or due to their complexity.

I hope the above points help you to appreciate our respective responsibilities in this area, but if further clarification is needed I would be delighted to meet you to discuss this further.

Yours faithfully Audit Manager

3.2 Email as follows:

To: Audit Partner

From: Audit

Manager **Subject:**

Makie fraud

I have written to the MD of Makie summarising our respective responsibilities for preventing and detecting fraud, and the work required by our professional standards in this area.

I hope this letter resolves the scenario, but the MD is threatening to sue the firm for negligence.

In order to prove negligence, the MD would have to prove that the firm didn't follow professional standards. As the standards clearly state that the responsibility for prevention and detection lies with management, this should not be an issue, although we do have a duty of care and a loss has been suffered.

I feel it is very unlikely that a claim would succeed in court but, due to negative publicity this would attract, we may wish to consider an out of court settlement if the situation escalates.

I will keep you informed of all developments.

Audit Manager

4 Redbrick plc

Email as follows:

To: The chair of the audit committee of Redbrick plc

From: Audit senior

Subject: Draft response to letter concerning Tharn Ltd

Thank you for your letter regarding the matters that have occurred in Tharn Ltd. This response only sets out our general responsibilities as auditors in respect of the discovery of fraud and error.

ISA (UK) 240 (Revised June 2016) (Updated January 2020), *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* is the auditing standard which deals with auditors' responsibilities in these cases.

The definition of fraud in ISA 240.11a is:

"Fraud is an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage."

It would appear on the basis of your letter as though the MD and FD of Tharn Ltd may have committed two types of fraud:

- Intentional misstatements resulting from fraudulent financial reporting (this can include misstated measurements resulting in the overstatement of revenue as you suggest the MD and FD have done)
- Intentional misstatements resulting from misappropriation of assets (this can include using business assets for personal use as in this case)

The responsibilities of those charged with governance and management in the context of fraud

The primary responsibility for the prevention and detection of fraud rests with both those charged with governance and management. This is likely to include the audit committee. Management should therefore have put in place appropriate procedures to prevent and detect fraud which may include the following:

- A culture of honesty
- Ethical behaviour policy and corporate guidelines
- Appropriate internal controls
- Appropriate policies for hiring, training and promoting employees

Inherent limitations of an audit in the context of fraud

ISAs (UK) recognise that there are inherent limitations in an audit whereby material misstatements may arise even where an audit is properly carried out. As a result, only reasonable assurance can be given, not absolute assurance.

You do not suggest the value of the fraudulent activity but, given the size of Tharn Ltd in the context of the Redbrick group, the materiality may be relatively small in the group financial statements, if not in Tharn's own financial statements, although this matter would need to be ascertained.

The risk of a material misstatement is higher from fraud than it is from error, as fraud can be complex and sophisticated and, by its nature, it is likely to be concealed to a greater or lesser extent. If there was any collusion between the MD and the FD then the concealment may be greatest. This is particularly the case given the seniority of their positions and thus their ability to override internal controls.

The probability of detection in the audit process will also depend on:

- the skill of the perpetrator(s)
- the scale of the fraud
- the frequency of the fraud
- the internal controls of the company

The responsibilities of the auditor for detecting material misstatement due to fraud

An auditor is required to obtain reasonable assurance that the financial statements, taken as a whole, are free from material misstatement whether caused by fraud or error. Absolute assurance is not possible therefore the discovery of fraud after the event does not of itself indicate that the audit has not been carried out in accordance with ISAs.

Audit evidence is persuasive, rather than conclusive; thus, for instance, normal reasonable reliance on internal controls can be rendered invalid by collusion.

Further evidence

Further evidence should be obtained as a matter of urgency to ascertain the nature, scope and materiality of the fraud. At that stage we can provide a more detailed response to the specific matters you raise.

Chapter 25

Assurance and related services

Introduction

Learning outcomes

- Explain the nature of a range of different assurance engagements, including those relating to environmental and sustainability disclosures
- Evaluate the evidence necessary to report at the appropriate level of assurance
- Evaluate risk in relation to the nature of the assurance engagement and the entity or process for a given scenario
- Design and determine procedures necessary to attain the relevant assurance objectives in a potentially complex scenario
- Appraise and explain the nature and purpose of forensic audit and prepare and plan procedures required to achieve a range of differing objectives
- Explain the roles and responsibilities that auditors may have with respect to a variety of different types of information and design procedures sufficient to achieve agreed objectives
- Explain the nature and purposes of due diligence procedures (for example: financial, commercial, operational, legal, tax, human resources) and plan procedures required to achieve a range of differing financial objectives

Specific syllabus references for this chapter are: 16(a)–(d), 17(b)–(d)

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	**Assurance** Use this section as a reminder of the work a firm does that is NOT audit- driven. Note how many different types of engagement there are.	**Approach** Work through each engagement and try to remember where you have met them before. **Stop and think** If required, would you be able to find these in your work book?	If asked to perform an engagement such as an assurance report at a service organisation, you will need to explain the firm's responsibilities and how they will be addressed by stating specific procedures and actions.	**IQ1: Assurance engagement (1)** This is a good starting point for revising assurance engagements but note how similar the acceptance procedures are to those in place for an audit. **IQ2: Assurance engagement (2)** This is a more practical test of your ability to describe suitable procedures for a particular scenario.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
2	**Engagements to review financial statements** These so-called 'mini-audits' are often preferred by companies exempt from audit – what benefits do you think they would provide? 'Mini audits' are not applicable in Bangladesh. However this concept has been introduced for knowledge and education prupose only.	**Approach** At all stages of the work, compare and contrast the approach used in reviews with those used in an audit. **Stop and think** Do you think this is as good as an audit? Does it depend on who it is being done for? Note the issue of a UK-specific version of the standard – what do you think will have contributed to this?	Beyond acceptance, planning and risk assessment, you will most likely be asked to generate suitable procedures remember that these are going to be enquiry and analytical procedures, so consider how they could be used to best effect in the situation presented. Note that interim reviews are more likely for listed companies to satisfy the expectations of the stock market.	N/A
3	**Due diligence** The 'used car problem' is a good way of explaining why due diligence is so important for organisations and how it is relied upon.	**Approach** Work through each part of the process and consider how it might actually be completed. **Stop and think** Have you or anyone you work with been involved in such an engagement?	Consider the different types of due diligence (beyond the basic financial aspects) and try to think of all the various questions that a potential purchaser would want to ask – how do you think you would answer them?	**IQ3: Due diligence** This is a great opportunity to put into practice what you have learned so far about due diligence – why does each of these issues matter?
4	**Reporting on prospective financial information (PFI)** Firms are often approached to examine financial forecasts for reasonableness – in this case though, it may not be shareholders or directors who you are working for.	**Approach** You met this type of work earlier in your studies. **Stop and think** Can you remember how you would have interrogated such forecasts in previous questions?	As ever, you will be assessed on your ability to apply knowledge to the situation presented in the scenario. You may need to consider acceptance procedures or describe the work you would do to evaluate either the preparation of the	**IQ4: Prospective financial information** Be as creative as you can and work methodically through all the items that you would expect to see in the forecasts given the information in the scenario.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
			forecasts or the assumptions underpinning them.	
5	**Agreed-upon procedures** No assurance is offered here – simply a statement of what was required. You should be familiar with any recent developments in this area.	**Approach** While reading through the section, consider what work this could include. **Stop and think** Does the lack of assurance make this work any less valuable to the client?	Make sure you understand the issues surrounding acceptance, planning, completion and communicating your findings.	N/A
6	**Compilation engagements** This is the application of accounting skills only and also offers no assurance.	**Approach** You should remember this from your earlier studies. **Stop and think** Have you ever been involved in this kind of work?	As with agreed-upon procedures, this will be practical but still require good awareness of the various stages of the work to be undertaken.	N/A
7	**Forensic audit** This is perhaps the most topical of all these non-audit engagements given the ongoing application of technology as a solution to a complex series of problems.	**Approach** The word 'forensic' may create images of criminal investigators wearing masks and gloves at a crime scene. However, the process of using tiny fragments of evidence to piece together the full story applies just as much to accountants as it does to the police. **Stop and think** Search online for the term 'forensic audit' and you will be rewarded with many examples!	Clearly, you cannot undertake such an engagement as part of your exam but you may still need to explain procedures that could be used to search for vital clues.	**IQ5: Forensic auditing** Use your knowledge of how inventory counts should work and then consider how this could be abused in the context of the question.

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Assurance

Section overview

- You have covered the concept of assurance and the principles in ISAE 3000 (Revised) in your earlier studies. This section provides a brief summary of the ISAE.
- ISAE 3402 and ISAE 3410 apply ISAE 3000 to an engagement to report on controls at a service organisation and engagements to report on greenhouse gas statements.
- ISAE 3420 concerns reporting on the pro forma information contained in a prospectus.

1.1 Introduction

You have been introduced to the concept of Assurance and International Standard on Assurance Engagements via ISAE 3000 , *Assurance Engagements Other than Audits or Reviews of Historical Financial Information* in the Assurance and Audit & Assurance papers at the Professional Level. The remainder of section 1 provides revision of the key points.

1.2 Concept of assurance

Definition

Assurance engagement: An assurance engagement is one in which a practitioner aims to obtain sufficient appropriate evidence in order to express a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

The most common type of assurance engagement is the audit. This has been covered earlier in this Workbook.

1.3 Assurance engagements other than audits or reviews of historical financial information

ISAE 3000 establishes **basic principles and essential procedures** for the performance of assurance engagements. It does not concern audits or reviews of historical financial information which are covered by ISAs and International Standards on Review Engagements (ISREs).

ISAE 3000 distinguishes between the two types of assurance engagement:

- **Reasonable assurance engagements** aim to reduce assurance engagement risk to an **acceptably low level** in the circumstances of the engagement as the basis for the assurance practitioner's conclusion. The practitioner's conclusion is expressed in a form that conveys the practitioner's opinion on the outcome of the measurement or evaluation of the underlying subject matter against criteria.
- **Limited assurance engagements** give a **lower level of assurance**. The nature, timing and extent of the procedures carried out by the practitioner in a limited assurance engagement would be limited compared with what is required in a reasonable assurance engagement. Nevertheless, the procedures performed should be planned to obtain a level of assurance which is **meaningful**, in the practitioner's professional judgement. To be meaningful, the level of assurance obtained by the practitioner is likely to enhance the intended users' confidence about the subject matter information to a degree that is clearly more than inconsequential.

Some of the salient points here may be summarised thus.

Assurance	Level of risk	Conclusion	Procedures	Example
Reasonable	Low	Positive expression – opinion expressed	High	"The management has operated an effective system of internal controls"
Limited	Acceptable in the circumstances	Negative expression – whether matters have come to attention indicating material misstatement	Limited, but still provides a meaningful level of assurance	"Nothing has come to our attention that indicates significant deficiencies in internal control"

Notes

1 The statutory audit is an example of a reasonable assurance engagement.

2 Remember the negative expression of opinion provides assurance of something in the absence of any evidence arising to the contrary. In effect the auditor is saying, 'I believe that this is reasonable because I have no reason to believe otherwise'.

Assurance engagements performed by professional accountants are normally intended to **enhance the credibility of information** about a subject matter by evaluating whether the subject matter conforms in all material respects with suitable criteria, thereby improving the likelihood that the information will meet the needs of an intended user. In this regard, the level of assurance provided by the professional accountant's conclusion conveys the degree of confidence that the intended user may place on the credibility of the subject matter.

There is a broad range of assurance engagements, which may include any of the following areas:

(a) Engagements to report on a wide range of subject matters covering financial and non-financial information

(b) **Attestation engagements** (where the underlying subject matter has not been measured or evaluated by the practitioner, and the practitioner concludes whether or not the subject matter information is free from material misstatement) and **direct engagements** (where the underlying subject matter has been measured and evaluated by the practitioner, and the practitioner then presents conclusions on the reported outcome in the assurance report)

(c) Engagements to report internally and externally

(d) Engagements in the private and public sector

Specific examples of assurance assignments include the following:

- Assurance attaching to special purpose financial statements
- Adequacy of internal controls
- Reliability and adequacy of IT systems
- Environmental and social matters
- Risk assessment
- Regulatory compliance
- Verification of contractual compliance

Elements of an assurance engagement

An assurance engagement will normally exhibit the following elements.

(a) A **three-party relationship** involving:

(1) a practitioner (the auditor or member of the engagement team)
(2) a responsible party (the client company)
(3) an intended user (eg, investors, regulators)

(b) **Subject matter** (ie, the information or issue to be attested)

(c) **Suitable criteria** (ie, standards or benchmarks to evaluate the subject matter)

(d) **Evidence** (sufficient appropriate evidence needs to be gathered to support the required level of assurance)

(e) An **assurance report** (a written report containing the practitioner's assurance conclusion is issued to the intended user, in the form appropriate to a reasonable assurance engagement or a limited assurance engagement)

Ethical requirements

ISAE 3000 requires practitioners to comply with the provisions of the IESBA Code related to assurance engagements, or other professional requirements, or requirements imposed by law or regulation, that are at least as demanding.

Acceptance and continuance

The practitioner must consider a number of factors before accepting or continuing an assurance engagement. These include whether:

- there is any reason to believe that relevant ethical requirements will not be satisfied;
- the practitioner is satisfied that the team have the appropriate competence and capabilities; or
- the basis on which the engagement is to be performed has been agreed.

The practitioner must also establish whether the preconditions for an assurance engagement are present.

Planning and performing the assurance engagement

Planning an assurance engagement will normally include consideration of the following:

- Terms of the engagement
- The expected timing and nature of the communication required
- Characteristics of the subject matter and the identified criteria
- The engagement process
- Understanding the entity, the environment and the risks
- Identifying intended users and their needs
- The extent to which the risk of fraud is relevant
- Resource requirements to complete the assignment
- The impact of the internal audit function

The practitioner should also:

- plan and perform the engagement with professional scepticism;
- obtain an understanding of the subject matter;
- assess the suitability of the criteria to evaluate or measure the subject matter; and
- consider materiality and engagement risk.

Quality management

As a minimum, the requirements of ISQM 1 should be followed for both the appointment of an engagement partner and the assignment of an appropriate team. The engagement partner will be responsible for satisfactory completion of the engagement, including direction, supervision, consultation and documentation. If required, the practitioner will also need to appoint a suitable engagement quality reviewer.

Obtaining evidence

The practitioner should obtain sufficient appropriate evidence on which to base the conclusion. The practitioner must consider risk and appropriate responses to those risks depending on whether the assurance engagement is a limited assurance engagement or a reasonable assurance engagement. The practitioner may also:

- obtain representations from responsible parties;
- consider the effect of subsequent events; and
- consider the effect of work performed by a practitioner's expert or an internal auditor.

Conclusions

The professional accountant must express a conclusion in writing that provides a level of assurance as to whether the subject matter conforms in all material respects with the identified suitable criteria.

The ISAE **does not require a standardised format for reporting**. However, it states that the assurance report will normally include the following elements:

- A title that indicates the report is an independent assurance report
- An addressee
- An identification or description of the **level of assurance** obtained by the practitioner
- The **subject matter information** (the outcome of the measurement or evaluation of the underlying subject matter against the criteria; for example, 'The company's internal controls operated effectively in terms of criteria X in the period')
- When appropriate, identification of the **underlying subject matter** (the phenomenon that is measured or evaluated; for example, the interim financial statements for the six months ended 31 March 20X5 in a review of interim financial statements)
- An identification of the **applicable criteria** (assertions, measurement methods, interpretations, regulations)
- A description of **significant inherent limitations** (for example, noting that a historical review of internal controls does not provide assurance that the same controls will continue to operate effectively in the future)
- When the applicable criteria are designed for a **specific purpose**, a statement alerting readers to this fact and that, as a result, the subject matter information may not be suitable for another purpose
- Responsible parties and their **responsibilities**, and the practitioner's responsibilities
- Statement that the work was performed **in accordance with ISAE 3000** (or another subject matter specific ISAE, where relevant)
- A statement that the firm of which the practitioner is a member **applies appropriate quality standards**
- A statement that the practitioner complies with, as a minimum, the **independence and other ethical requirements** of the International Ethics Standards Board for Accountants' International Code of Ethics for Professional Accountants (including International Independence Standards) (IESBA Code), which is founded on fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behavior.

- An **informative summary of work performed** (including, for limited assurance engagements, a statement that the nature, timing and extent of work performed is different from that carried out for a reasonable assurance engagement, and therefore a substantially lower level of assurance is provided)
- Conclusion
- Signature
- Report date
- Location of practitioner giving the report

The practitioner's conclusion provides a level of assurance about the subject matter. **Absolute assurance is generally not attainable** as a result of such factors as:

- the use of selective testing;
- the inherent limitations of control systems;
- the fact that much of the evidence available to the practitioner is persuasive rather than conclusive;
- the use of judgement in gathering evidence and drawing conclusions based on that evidence; and
- in some cases, the characteristics of the subject matter.

Therefore, practitioners ordinarily undertake engagements to provide one of only two distinct levels: reasonable assurance and limited assurance. These engagements are affected by various elements; for example, the degree of precision associated with the subject matter, the nature, timing and extent of procedures, and the sufficiency and appropriateness of the evidence available to support a conclusion.

Unmodified and modified conclusions

An unmodified opinion is expressed when the practitioner concludes the following:

- In the case of a reasonable assurance engagement, that the subject matter information is prepared, in all material respects, in accordance with the applicable criteria
- In the case of a limited assurance engagement, that, based on the procedures performed and the evidence obtained, no matters have come to the attention of the practitioner that causes them to believe that the subject matter information is not prepared in all material respects, in accordance with the applicable criteria.

A modified conclusion will be issued where the above does not apply.

1.3.1 Conforming amendments

A number of conforming amendments have previously been made to ISAE 3000 (Revised) resulting from the changes made to ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* by the IAASB following the conclusion of its NOCLAR (non-compliance with laws and regulations) project. These became effective for periods beginning on or after 15 December 2017. The key points are as follows.

Planning and performing the engagement

The practitioner may have additional responsibilities under law, regulation or ethical requirements regarding non-compliance with laws and regulations which differ or go beyond responsibilities under ISAE 3000.

Communication with management and those charged with governance

Issues surrounding the requirement to communicate suspected non-compliance with laws and regulations may be complex. For example in some jurisdictions communication may be restricted or prohibited. The practitioner may consider it appropriate to obtain legal advice.

Reporting to an appropriate authority outside the entity

This may be appropriate for the following reasons:

(a) Law, regulation or ethical requirements require it

(b) The practitioner has determined that reporting is an appropriate action in the circumstances

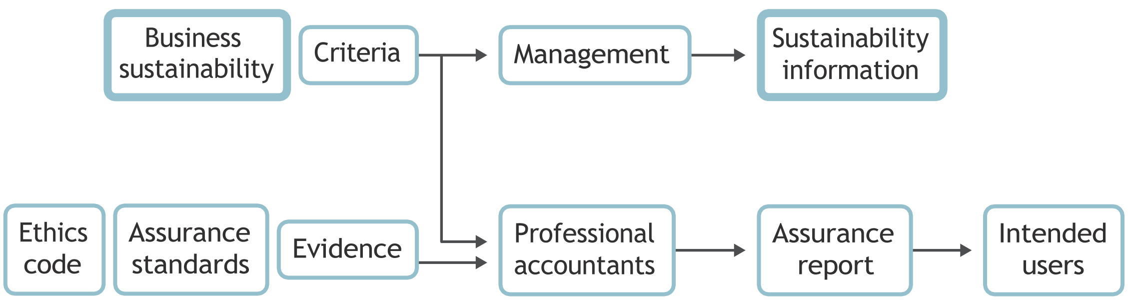
(c) Law, regulation or ethical requirements provide the practitioner with the right to do so

In some instances reporting to authorities outside the entity may give rise to confidentiality issues. The practitioner may consult internally, obtain legal advice or consult with a regulator or professional body in order to understand the implications of different courses of action.

1.4 ICAEW Publication

The ICAEW publication *Sustainability Assurance: Your Choice* summarises the IAASB approach to assurance as follows:

Figure 25.1: IAASB approach to assurance engagements



Interactive question 1: Assurance engagement (1)

You are the auditor of Knoll plc. Investors in the company have recently expressed concern regarding the company's compliance with corporate governance requirements. As a result you have been asked by the directors to undertake an assurance engagement to assess the risk management procedures adopted by Knoll plc.

Requirements

1.1 Explain why the investors would require assurance regarding risk management procedures.

1.2 Identify the elements in the above scenario normally exhibited by an assurance engagement.

1.3 Explain the matters you would consider before accepting this engagement.

See **Answer** at the end of this chapter.

Interactive question 2: Assurance engagement (2)

One of your audit clients, Kelly plc, has borrowed £30 million from Bond Bank plc. The lending agreement requires that the company meets certain covenants and that the directors of Kelly plc provide the bank with an annual statement of compliance. Your firm has been asked to report on this statement and the bank have requested that the report should be made directly to them.

Requirements

2.1 To whom should the letter of engagement be addressed?

2.2 List the key issues which the letter of engagement should cover.

2.3 Outline the procedures which the auditor would perform in order to report on the compliance statement.

See **Answer** at the end of this chapter.

1.5 Assurance reports on controls at a service organisation

1.5.1 Introduction

ISAE 3402, *Assurance Reports on Controls at a Service Organisation* expands on how ISAE 3000 (Revised) is to be applied in a reasonable assurance engagement to report on controls at a service organisation. It deals with assurance engagements carried out by a practitioner to provide a report for user entities and their auditors on the controls at a service organisation. It only applies when the service organisation is responsible for, or otherwise able to make a statement about, the suitable design of controls. This means that it does not apply where the assurance engagement is to:

(a) Report only on whether controls at the service organisation operated as described; or

(b) Report on controls at a service organisation other than those related to a service that is likely to be relevant to user entities' internal control as it relates to financial reporting

Note: Minor conforming amendments have been made to ISAE 3402 resulting from the changes made to ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* made by the IAASB following the conclusion of its NOCLAR (non-compliance with laws and regulations) project.

1.5.2 Objectives

ISAE 3402 states that the objectives of the service auditor are as follows:

(a) To obtain reasonable assurance about whether, in all material respects, based on suitable criteria:

   (1) The service organisation's description of its system fairly presents the system as designed and implemented throughout the specified period or as at a specified date

   (2) The controls related to the control objectives stated in the service organisation's description of its system were suitably designed throughout the specified period

   (3) Where included in the scope of the engagement, the controls operated effectively to provide reasonable assurance that the control objectives stated in the service organisation's description of its system were achieved throughout the period

(b) To report on the matters in (a) above

1.5.3 Requirements

ISAE 3402 requires the service auditor to carry out the following procedures:

- Consider acceptance and continuance issues
- Assess the suitability of the criteria used by the service organisation
- Consider materiality with respect to the fair presentation of the description, the suitability of the design of controls and, in the case of a type 2 report, the operating effectiveness of controls
- Obtain an understanding of the service organisation's system

- Obtain evidence regarding:
  - The service organisation's description of its system
  - Whether controls implemented to achieve the control objectives are suitably designed
  - The operating effectiveness of controls (when providing a type 2 report)
- Determine whether, and to what extent, to use the work of the internal auditors (where there is an internal audit function)

Notes

1 A 'type 1' report is a report on the description and design of controls at a service organisation.

2 A 'type 2' report is a report on the description, design and operating effectiveness of controls at a service organisation.

1.5.4 Written representations

The service auditor must request the service organisation to provide the following written representations in the form of a representation letter addressed to the service auditor:

(a) Reaffirmation of the statement accompanying the description of the system

(b) That it has provided the service auditor with all relevant information and access

(c) That it has disclosed to the service auditor any of the following of which it is aware:

(1) Non-compliance with laws and regulations, fraud or uncorrected deviations

(2) Design deficiencies in controls

(3) Instances where controls have not operated as described

(4) Subsequent events

1.5.5 Content of the service auditor's assurance report

Note: This standard was issued prior to the adoption of the quality management standards in 2021 when ISQC 1 and the terms 'quality control' and 'engagement quality control review' were still in use – however, in this instance you can assume that these practices are referring to what you understand to be quality management and engagement quality reviews respectively under ISQM 1.

ISAE 3402 requires the report to contain the following basic elements:

(a) A title that clearly indicates that the report is an independent service auditor's assurance report

(b) An addressee

(c) Identification of:

  (1) the service organisation's description of its system, and the service organisation's statement; and

  (2) those parts of the service organisation's description of its system that are not covered by the service auditor's opinion (if any)

(d) Identification of the applicable criteria, and the party specifying the control objectives

(e) A statement that the report is intended only for user entities and their auditors

(f) A statement that the service organisation is responsible for:

  (1) preparing the description of its system, and the accompanying statement;

  (2) providing the services covered by the service organisation's description of its system;

  (3) stating the control objectives; and

(4) designing and implementing controls to achieve the control objectives stated in the service organisation's description of its system

(g) A statement that it is the service auditor's responsibility to express an opinion on the service organisation's description, on the design of controls related to the control objectives, and in the case of a type 2 report on the operating effectiveness of those controls

(h) A statement that the firm applies ISQC 1

(i) A statement that the practitioner complies with the IESBA Code or other professional requirements

(j) A statement that the engagement was performed in accordance with ISAE 3402

(k) A summary of the service auditor's procedures

(l) A statement of the limitations of controls

(m) The service auditor's opinion expressed in a **positive** form

(n) Date

(o) Name of the service auditor

1.5.6 Auditor's opinion

For a type 1 report the service auditor will express their opinion as to whether the description fairly presents the service organisation's system and that the controls related to the control objectives stated in that description were suitably designed.

In addition to the above for a type 2 report the auditor will also express an opinion as to whether the controls tested operated effectively throughout the specified period.

Professional skills focus: Applying judgement

It will be far from straightforward determining the operation of an outsourced service organisation's internal controls. You need to display strong judgement to evaluate what obstacles exist in your mission to issue an appropriate opinion.

1.5.7 Modified opinions

Where the auditor cannot agree with the details of the report or is unable to obtain sufficient appropriate evidence, a modified report must be issued.

1.6 Assurance engagements on greenhouse gas statements

1.6.1 Background

In June 2012, the IAASB issued ISAE 3410, *Assurance Engagements on Greenhouse Gas Statements*.

Note: Minor conforming amendments have been made to ISAE 3410 resulting from the changes made to ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* by the IAASB following the conclusion of its NOCLAR (non-compliance with laws and regulations) project.

Definitions

Greenhouse gas statement: A statement setting out constituent elements and quantifying an entity's greenhouse gas emissions for a period (sometimes known as an emissions inventory) and, where applicable, comparative information and explanatory notes including a summary of significant quantification and reporting policies.

Greenhouse gases (GHGs): Carbon dioxide (CO_2) and any other gases required by the applicable criteria to be included in the GHG statement, such as: methane; nitrous oxide; sulphur hexafluoride; hydrofluorocarbons; perfluorocarbons; and chlorofluorocarbons.

All businesses emit GHGs either directly or indirectly. Recently the demand for companies to publish information about their emissions has increased. As a result the public require confidence that GHG statements are reliable. ISAE 3410 aims to enhance this confidence. Reasons for preparing a GHG statement include the following:

- It may be required under a regulatory disclosure regime.
- It may be required as part of an emissions trading scheme.
- A company may wish to make voluntary disclosures.

1.6.2 Assurance

An engagement performed in accordance with ISAE 3410 must also comply with the requirements of ISAE 3000 (Revised). Depending on the circumstances the engagement may provide limited or reasonable assurance about whether the GHG statement is free from material misstatement, whether due to fraud or error. ISAE 3410 does not specify the circumstances under which a reasonable or limited assurance engagement will be performed. This will normally be determined by law or regulation or based on the reason behind the performance of the engagement.

1.6.3 Process

The key stages for this type of engagement are similar to those for any assurance assignment. These are as follows:

- Plan the engagement
- Obtain an understanding of the entity and its internal control
- Identify and assess the risks of material misstatement
- Design overall responses to the assessed risk of material misstatement and further procedures
- Obtain written representations
- Form an assurance conclusion

The detail of the ISAE adopts a 'two column approach' detailing specific issues which apply to a limited assurance engagement and those which apply to a reasonable assurance engagement. For example:

Understanding the entity

The understanding required to perform a limited assurance engagement will be less than that required for a reasonable assurance engagement. In particular, for a limited assurance engagement there is no requirement to:

- obtain an understanding of control activities relevant to the engagement (although an understanding of other aspects of internal control should be obtained); or
- evaluate the design of controls and determine whether they have been implemented.

Identifying and assessing risk

Risk assessment procedures will be less extensive in a limited assurance engagement. For example, the assessment of the risks of material misstatement with respect to material types of emissions and disclosures does not need to be performed at the assertion level.

Overall responses and further procedures

ISAE 3410 identifies varied procedures depending on the assurance provided. In particular, the nature and extent of procedures will depend on the nature of the assignment. For example, analytical procedures for a reasonable assurance engagement should be assertion based.

1.6.4 Reporting

Note: This standard was issued prior to the adoption of the quality management standards in 2021 when ISQC 1 and the terms 'quality control' and 'engagement quality control review' were still in use – however, in this instance you can assume that these practices are referring to what you understand to be quality management and engagement quality reviews respectively under ISQM 1.

ISAE 3410 requires the assurance report to include the following basic elements:

(a) A title which clearly indicates that the report is an independent assurance report

(b) The addressee

(c) Identification and description of the level of assurance, either reasonable, or limited

(d) Identification of the GHG statement

(e) A description of the entity's responsibilities

(f) A statement that the GHG quantification is subject to inherent uncertainty

(g) If the GHG statement includes emissions deductions that are covered by the practitioner's conclusion, identification of those emissions deductions, and a statement of the practitioner's responsibility with respect to them

(h) Identification of the applicable criteria

(i) A statement that the firm applies ISQC 1

(j) A statement that the practitioner complies with the IESBA Code or other professional requirements

(k) A description of the practitioner's responsibility including:

  (1) a statement that the engagement was performed in accordance with ISAE 3410; and

  (2) a summary of the work performed as the basis of the practitioner's conclusion. In the case of a limited assurance engagement, this must include a statement that the procedures performed in a limited assurance engagement vary in nature and timing from, and are less in extent than for a reasonable assurance engagement. Consequently the level of assurance obtained in a limited assurance engagement is substantially lower than the assurance that would have been obtained had a reasonable assurance engagement been performed.

(l) In a reasonable assurance engagement the conclusion shall be expressed in a positive form. In a limited assurance engagement the conclusion must be expressed in a form that conveys whether a matter(s) has come to the practitioner's attention to cause the practitioner to believe that the GHG statement is not prepared, in all material respects in accordance with applicable criteria.

(m) If the practitioner expresses a conclusion that is modified, the report must include a section that provides a description of the matter giving rise to the modification and a section containing the modified opinion.

(n) The practitioner's signature

(o) The date of the assurance report

(p) The location and jurisdiction where the practitioner practises

Appendix 2 of ISAE 3410 includes illustrative examples of reports for both reasonable and limited assurance engagements.

1.7 Reporting on information contained in a prospectus

1.7.1 Reporting on the compilation of pro forma financial information

Assurance assignments relate to a wide range of engagements, the nature of which is likely to be determined by contract as well as by statute. They include major investment, divestment, financing and restructuring strategies where additional credibility is needed for one or more of the contracting parties. In December 2011 the IAASB issued ISAE 3420, *Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus*. The project was undertaken in the context of the increasing globalisation of capital markets that has made it important for the financial information used in capital market transactions to be understandable across borders and for assurance to be provided to enhance users' confidence in how such information is produced. The key points to note are as follows:

- Pro forma financial information is defined as financial information shown together with adjustments to illustrate the impact of an event or transaction on unadjusted financial information as if the event had occurred or the transaction had been undertaken at an earlier date selected for the purposes of illustration. This is achieved by applying pro forma adjustments to the unadjusted financial information.
- The practitioner's sole responsibility is to report on whether the pro forma financial information has been compiled in all material respects by the responsible party on the basis of applicable criteria. The practitioner has no responsibility to compile the pro forma information.
- The practitioner must perform procedures to assess whether the applicable criteria used in the compilation of the pro forma information provide a reasonable basis for presenting the significant effects directly attributable to the event or transaction. The work must also involve an evaluation of the overall presentation of the pro forma financial information.
- To maximise its applicability globally ISAE 3420 prescribes the wording of the opinion although it allows two alternative forms:
  - The pro forma financial information has been compiled, in all material respects, on the basis of the (applicable criteria).
  - The pro forma financial information has been properly compiled on the basis stated.

1.7.2 Other guidance

In the UK, the APB (now FRC (UK)) has also issued guidance in this area in Standard for Investment Reporting (SIR) 1000, *Investment Reporting Standards Applicable to All Engagements in Connection with an Investment Circular*.

Definition

Investment circular: Any document issued by an entity pursuant to statutory or regulatory requirements relating to securities on which it is intended that a third party should make an investment decision, including a prospectus, listing particulars, a circular to shareholders or similar document.

The approach which the reporting accountant is required to take is very similar to that for the statutory audit:

- Agree the terms
- Comply with ethical requirements and quality management standards
- Plan the work and consider materiality
- Obtain sufficient appropriate evidence
- Document significant matters
- Adopt an attitude of professional scepticism
- Express an opinion (modified if required)

Note: The detail of ISAE 3420 and SIR 1000 is not examinable.

CHAPTER 25

2 Engagements to review financial statements

Section overview

- A review is a type of assurance service which provides a reduced degree of assurance concerning the proper preparation of financial statements.
- One specific example is the review of interim financial information that may be performed by the independent auditor.
- Where no material matters come to the attention of the auditor an expression of negative assurance should be given.

2.1 Nature of a review engagement

The objective of a review of financial statements is to enable a practitioner/auditor to state **whether anything has come to the practitioner/auditor's attention** that causes the practitioner/auditor to believe that the financial statements are not prepared, in all material respects, in **accordance with an identified financial reporting framework**.

An **external review** is an exercise similar to an audit, which is designed to give a **reduced degree of assurance** concerning the proper preparation of historical financial information. **Negative assurance** is given on review assignments.

Guidance is provided for this International Standard on Review Engagements using ISRE 2400 , *Engagements to Review Historical Financial Statements*. This ISRE applies to reviews of historical financial statements by a practitioner other than the entity's auditors. It does not address a review of an entity's financial statements or interim financial information performed by the auditor of the entity.

In September 2012, the IAASB issued ISRE 2400), effective for reviews of financial statements for periods ended on or after 31 December 2013. The revised ISRE aims to describe the review as a distinct assurance engagement which is different from an audit in key respects, including the performance of the engagement and reporting. It has been issued in response to an increased demand for services other than audit. This has been driven by the fact that in many jurisdictions there are exemptions from the mandatory audits of financial statements. In the UK, for example, companies which meet the small company criteria are exempt from statutory audits. These small companies, as well as unincorporated businesses, may want their financial statements to be reviewed by chartered accountants, despite not being required to have an audit.

Notes

1 Conforming amendments have been made to ISRE 2400 (Revised), resulting from the changes made to ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* by the IAASB following the conclusion of its NOCLAR (non-compliance with laws and regulations) project.

2 This ISRE has been adopted in Bangladesh.

2.2 Engagement quality

ISRE 2400 (Revised) highlights a number of factors to ensure that engagement quality is maintained. These include the following:

- Compliance with ethical standards including independence requirements.
- Planning and performing the engagement with professional scepticism.
- Exercising professional judgement in the performance of the review engagement. In a review this judgement is essential particularly regarding decisions about the procedures which need to be performed and assessing the sufficiency and appropriateness of evidence obtained.
- Requiring the engagement partner to take overall responsibility for the engagement, including direction, supervision, planning and performance in compliance with professional standards and the firm's quality management policies. The engagement partner must also ensure that the team has the appropriate competence and capabilities including assurance skills.

2.3 Acceptance and continuance

One of the important aspects of the revised ISRE is that it includes safeguards to ensure that a review engagement is not undertaken unless it is appropriate to the circumstances. For example, if the practitioner believes that an audit would be more appropriate, this should be recommended to the client. In other cases where circumstances preclude an assurance engagement, a compilation engagement or other accounting service may be suggested.

The terms of the engagement should be recorded in an engagement letter or other written agreement. It should include the following matters:

(a) The intended use and distribution of the financial statements and any restrictions on use

(b) Identification of the applicable financial reporting framework

(c) The objectives and scope of the review engagement

(d) The responsibilities of the practitioner

(e) The responsibilities of management (including the responsibility to provide the practitioner with all information required)

(f) A statement that the engagement is not an audit and that the practitioner will not express an audit opinion

(g) Reference to the expected form and content of the report to be issued (and a statement that the report may differ from this)

2.4 Materiality

The practitioner should apply similar materiality considerations as would be applied if an audit opinion on the financial statements were being given. ISRE 2400 (Revised) requires the practitioner to determine materiality for the financial statements as a whole and apply this in designing procedures and evaluating results. Although there is a greater risk that misstatements will not be detected in a review than in an audit, the judgement as to what is material is made by reference to the information on which the practitioner is reporting and the needs of those relying on that information, not to the level of assurance provided.

2.5 Procedures

In overview the work performed by the practitioner is as follows:

(a) Inquiry and analytical procedures are performed to obtain sufficient appropriate audit evidence to come to a conclusion about the financial statements as a whole. These must address all material items in the financial statements including disclosures and must address areas where material misstatements are likely.

(b) If sufficient appropriate evidence has not been obtained by these procedures, further procedures are performed.

(c) Additional procedures are performed where the practitioner becomes aware of matters that indicate that the financial statements may be materially misstated.

2.5.1 Understanding the business

The practitioner is required to obtain an understanding of the business including:

- Relevant industry
- Nature of the entity (eg, operations, ownership structure)
- Accounting systems and accounting records
- Selection and application of accounting policies

2.5.2 Inquiry

Inquiry is one of the key techniques used by the practitioner in a review. Evaluating the responses is an integral part of the process. Specific inquiries include the following matters:

- How management makes significant accounting estimates
- Identification of related parties and related party transactions
- Whether there are significant, unusual or complex transactions, events or matters that have affected or may affect the financial statements (eg, significant changes in the entity's business, changes to terms of finance or debt covenants, significant transactions near the end of the reporting period)
- Actual, suspected or alleged fraud, illegal acts or non-compliance with laws and regulations
- Whether management has identified and addressed events after the reporting period
- Basis for management's assessment of the entity's ability to continue as a going concern
- Events or conditions that cast doubt on the entity's ability to continue as a going concern
- Material commitments, contractual obligations or contingencies
- Material non-monetary transactions or transactions for no consideration in the reporting period

2.5.3 Analytical procedures

Analytical procedures can help the practitioner with:

- obtaining or updating an understanding of the entity and its environment;
- identifying inconsistencies or variances from expected trends, values or norms;
- providing corroborative evidence in relation to inquiry or other analytical procedures; and
- serving as additional procedures when the practitioner becomes aware of matters that indicate that the financial statements may be materially misstated.

In designing analytical procedures ISRE 2400 (Revised) requires the practitioner to consider whether the data available is adequate for these purposes.

2.5.4 Other procedures

The practitioner must obtain evidence that the financial statements agree with, or reconcile to, the underlying accounting records.

Written representations will be sought stating that management have fulfilled their responsibilities and that certain matters have been disclosed (eg, re related parties, fraud, going concern).

2.5.5 Procedures to address specific circumstances

ISRE 2400 (Revised) identifies three areas which must be addressed specifically:

- related parties
- fraud and non-compliance with laws and regulations
- going concern

2.5.6 Related parties

The practitioner is required to remain alert for circumstances which might indicate the existence of related-party relationships or transactions. Where transactions outside the entity's normal course of business are identified the practitioner must discuss them with management, in particular inquiring about the nature of the transactions, whether related parties are involved and the business rationale (or lack of) of those transactions.

2.5.7 Fraud and non-compliance with laws and regulations

Where there is an indication of fraud or non-compliance with laws and regulations, the practitioner must:

- communicate the matter to the appropriate level of management/those charged with governance;
- request management's assessment of the effects if any on the financial statements;
- consider the implications for the practitioner's report;
- determine whether law, regulation or ethical requirements require that the matter should be reported to a third party outside the entity; and
- determine whether law, regulation or ethical requirements establish responsibilities under which reporting to an authority outside the entity may be appropriate.

When making decisions about reporting identified or suspected non-compliance with laws and regulations to an appropriate authority outside the entity the practitioner may have to consider complex issues. The practitioner may consult internally, obtain legal advice or consult with a regulator or professional body in order to understand the implications of different courses of action.

2.5.8 Going concern

If the practitioner becomes aware of conditions (financial, operating or other) which cast significant doubt on the entity's ability to continue as a going concern, he/she must ask management about plans for future actions that might have a bearing on this. The feasibility of any plans should also be assessed. The practitioner must evaluate whether management's responses are sufficient to determine whether the going concern assumption still applies and should assess responses in the light of all other information obtained during the review.

2.6 Conclusions and reporting

ISRE 2400 (Revised) states that the practitioner must express an unmodified conclusion on the financial statements as a whole when the practitioner has obtained limited assurance to be able to conclude that nothing has come to the practitioner's attention that causes them to believe that the financial statements are not prepared in all material respects in accordance with the applicable financial reporting framework.

The following is an example of a report with an unmodified opinion taken from ISRE 2400 (Illustration 1):

Independent Practitioner's Review Report

(Appropriate addressee)

Report on the financial statements

We have reviewed the accompanying financial statements of ABC Company, which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the International Financial Reporting Standard for Small and Medium-sized Entities, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Practitioner's Responsibility

Our responsibility is to express a conclusion on the accompanying financial statements. We conducted our review in accordance with International Standard on Review Engagements (ISRE) 2400 (Revised), Engagements to Review Historical Financial Statements. ISRE 2400 (Revised) requires us to conclude whether anything has come to our attention that causes us to believe that the financial statements, taken as a whole, are not prepared in all material respects in accordance with the applicable financial reporting framework. This Standard also requires us to comply with relevant ethical requirements.

A review of financial statements in accordance with ISRE 2400 (Revised) is a limited assurance engagement. The practitioner performs procedures, primarily consisting of making enquiries of management and others within the entity, as appropriate, and applying analytical procedures, and evaluates the evidence obtained.

The procedures performed in a review are substantially less than those performed in an audit conducted in accordance with International Standards on Auditing. Accordingly, we do not express an audit opinion on these financial statements.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the financial statements do not present fairly, in all material respects (or do not give a true and fair view of) the financial position of ABC Company as at December 31, 20X1, and (of) its financial performance and cash flows for the year then ended, in accordance with the International Financial Reporting Standard for Small and Medium-sized Entities.

Date

PRACTITIONER

Address

For financial statements prepared using a compliance framework (as opposed to a fair presentation framework) the following alternative opinion is allowed:

"Based on our review, nothing has come to our attention that causes us to believe that the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework."

If it is necessary to modify their conclusion, the practitioner must use an appropriate heading ie, Qualified Conclusion, Adverse Conclusion or Disclaimer of Conclusion. A description of the matter must also be given in a basis for conclusion paragraph immediately before the conclusion paragraph.
The practitioner may conclude that the financial statements are materially misstated. The matters may have the following effects.

Impact	**Effect on report**
Material	Express a qualified conclusion of negative assurance
Pervasive	Express an adverse conclusion that the financial statements do not give a true and fair view

The practitioner may feel that there was an inability to obtain sufficient appropriate evidence (there has been a limitation in the scope of the work they intended to carry out for the review). If so, they should describe the limitation. The limitation may have the following effects.

Impact	**Effect on report**
Material to one area	Express a qualified conclusion of negative assurance due to amendments which might be required if the limitation did not exist
Pervasive	Do not provide any assurance

2.7 Review of interim financial information performed by the independent auditor of the entity

This subject is covered by ISRE 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity* which gives guidance on the specific review engagements that fall outside the scope of ISRE 2400 (i.e., because they are performed by the entity's auditor). The key distinction between the two standards is that ISRE 2410 is written on the basis that the independent auditor will be able to make use of the knowledge of the entity that has been obtained during the audit in performing the review, while this knowledge is not available to a practitioner who is not the entity's auditor.

2.7.1 Procedures

The procedures outlined below follow the same pattern as an audit but, because this is a review not an audit, which gives a lower level of assurance, they are not as detailed as audit procedures.
However, the auditor is still expected to comply with the same ethical and quality management requirements, and to plan and perform the engagement with an attitude of professional scepticism. The auditor should also agree the terms of the engagement to manage any expectation gap issues, including those relevant to going concern.

The auditor should possess sufficient understanding of the entity and its environment to understand the types of misstatement that might arise in interim financial information and to plan the relevant procedures (mainly inquiry and analytical review) to enable them to ensure that the financial information is prepared in accordance with the applicable financial reporting framework. This will usually include the following:

- Reading last year's audit and previous review files
- Considering any significant risks that were identified in the prior year audit
- Reading the most recent and comparable interim financial information
- Considering materiality

- Considering the nature of any corrected or uncorrected misstatements in last year's financial statements
- Considering significant financial accounting and reporting matters of ongoing importance
- Considering the results of any interim audit work for this year's audit
- Considering the work of internal audit
- Reading management accounts and commentaries for the period
- Considering any findings from prior periods relating to the quality and reliability of management accounts
- Asking management what their assessment is of the risk that the interim financial statements might be affected by fraud
- Asking management whether there have been any significant changes in business activity and, if so, what effect they have had
- Asking management about any significant changes in internal controls and the potential effect on preparing the interim financial information
- Asking how the interim financial information has been prepared and the reliability of the underlying accounting records
- As part of understanding the entity and its environment, the auditor should consider the possible existence of events or conditions that might cast significant doubt on the entity's ability to continue as a going concern, including any areas of material uncertainty identified as part of the auditor's application of ISAs 315 (Revised) and 570 (Revised).

A recently appointed auditor should obtain an understanding of the entity and its environment, as it relates to both the interim review and final audit.

The key elements of the review will be as follows:

- **Inquiries** of accounting and finance staff
- **Analytical procedures**

Ordinarily, procedures would include the following:

- Reading the minutes of meetings of shareholders, those charged with governance and other appropriate committees
- Considering the effect of matters giving rise to a modification of the audit or review report, accounting adjustments or unadjusted misstatements from previous audits
- If relevant, communicating with other auditors auditing different components of the business
- Performing analytical procedures designed to identify relationships and unusual items that may reflect a material misstatement
- Reading the interim financial information and considering whether anything has come to the auditors' attention indicating that it is not prepared in accordance with the applicable financial reporting framework
- Agreeing the interim financial information to the underlying accounting records
- For group interim financial information, reviewing consolidation adjustments for consistency
- Reviewing relevant correspondence with regulators

Auditors should make inquiries of members of management responsible for financial and accounting matters about the following:

- Whether the interim financial information has been prepared and presented in accordance with the applicable financial reporting framework
- Whether there have been changes in accounting policies

- Whether new transactions have required changes in accounting principles
- Whether there are any known uncorrected misstatements
- Whether there have been unusual or complex situations, such as disposal of a business segment
- Significant assumptions relevant to fair values
- Whether related-party transactions have been accounted for and disclosed correctly
- Significant changes in commitments and contractual obligations
- Significant changes in contingent liabilities including litigation or claims
- Compliance with debt covenants
- Matters about which questions have arisen in the course of applying the review procedures
- Significant transactions occurring in the last days of the interim period or the first days of the next
- Knowledge or suspicion of any fraud
- Knowledge of any allegations of fraud
- Knowledge of any actual or possible non-compliance with laws and regulations that could have a material effect on the interim financial information
- Whether all events up to the date of the review report that might result in adjustment in the interim financial information have been identified
- Whether management has changed its assessment of the entity being a going concern and if so, consider whether such a change is appropriate in line with other evidence collected during the review

When comparative interim financial information is presented the auditor should consider whether accounting policies are consistent and whether the comparative amounts agree with the information presented in the preceding interim financial report.

The auditor should evaluate discovered misstatements individually and in aggregate to see if they are material. The amount designated by the auditor, below which misstatements that have come to the auditor's attention need not be aggregated, is the amount below which the auditor believes misstatements are clearly trivial.

The auditor should obtain **written representations** from management that it acknowledges its responsibility for the design and implementation of internal control, that the interim financial information is prepared and presented in accordance with the applicable financial reporting framework and that the effect of uncorrected misstatement is immaterial (a summary of these should be attached to the representations). Written representation should also state that all **significant facts** relating to **frauds or non-compliance with laws and regulations** and all **significant subsequent events** have been disclosed to the auditor. Should future action be necessary to address any going concern issues, management should submit their plan for this action and include its feasibility.

The auditor should read the other information accompanying the interim financial information to ensure that it is not inconsistent with it.

If the auditors believe a matter should be adjusted in the interim financial information, they should **inform management** as soon as possible. If management does not respond within a reasonable time, then the auditors should inform those charged with governance. If they do not respond, then the auditor should consider whether to modify the report or to withdraw from the engagement and the final audit if necessary. If the auditors uncover fraud or non-compliance with laws and regulations, they should communicate that promptly with the **appropriate level of management**. The auditors should communicate matters of interest arising to those charged with governance.

Professional skills focus: Structuring problems and solutions

Standards like this may appear intimidating, especially if there are long lists of procedures that you are not entirely sure you can always remember. The good news is that examinable standards are all available for you to use in the open book permitted text (remember that the supporting information with paragraphs that start with an "A" contain lots of detail that may be helpful).

2.7.2 Reporting

The auditor should not date the review report earlier than the date on which the financial information is approved by management and those charged with governance.

The following example of a review report is taken from ISRE 2410 (Appendix 4) to illustrate the wording that would be used.

Report on Review of Interim Financial Information
Introduction

We have reviewed the accompanying balance sheet of ABC Entity as of March 31, 20X1 and the related statements of income, changes in equity and cash flows for the three-month period then ended, and a summary of significant accounting policies and other explanatory notes.1 Management is responsible for the preparation and fair presentation of this interim financial information in accordance with [indicate applicable financial reporting framework]. Our responsibility is to express a conclusion on this interim financial information based on our review.

Scope of Review
We conducted our review in accordance with International Standard on Review Engagements 2410, Review of Interim Financial Information Performed by the Independent Auditor of the Entity.2 A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion
Based on our review, nothing has come to our attention that causes us to believe that the accompanying interim financial information does not give a true and fair view of (or "does not present fairly, in all material respects,") the financial position of the entity as at March 31, 20X1, and of its financial performance and its cash flows for the three-month period then ended in accordance with [applicable financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not International Financial Reporting Standards].

There are examples of modified reports in Appendices 4, 5 and 6 of ISRE 2410 to illustrate how the auditor would communicate their findings if unable to deliver a standard conclusion.

3 Due diligence

Section overview

- Due diligence is a type of review engagement.
- There are a number of different types of due diligence report.
  - Financial due diligence
  - Commercial due diligence
  - Operational due diligence
  - Technical due diligence
  - IT due diligence
  - Legal due diligence
  - Human resources due diligence

3.1 Introduction

Businesses need adequate, relevant and reliable information in order to take decisions. However, problems may arise where one party to the transaction has more or better information than the other party (this is sometimes called information asymmetry). This problem is made worse by the fact that frequently there is an incentive to use this superior position to gain an unfair advantage in a deal. The situation can be highlighted by the following illustration.

Context example: The used car problem

In selling a used car the owner (the seller) has more information than the potential buyer, and has the incentive to use this information to gain an advantage. Thus, if it is a good car the seller will say so, but if it is a bad car the seller will probably still say it is good.

The buyer is at a disadvantage, as they have less information. They have difficulty in distinguishing a good car from a bad car and may be reluctant to purchase.

There is thus a role for assurance here in the form of an AA or RAC survey to equalise information and encourage trading. As a result, both parties may benefit.

The situation for many types of corporate transformation arrangement is similar to the used car example. However, statutory audited financial statements may not be sufficient to narrow the information gap, often because they are prepared for a different purpose.

A greater, and more specific, level of assurance may therefore be needed for acquisitions, mergers, joint ventures and management buy-outs (MBOs). The most common type of assurance in this context is a **'report of due diligence'**.

3.2 The nature of due diligence

A due diligence review is a specific type of review engagement.

While it can apply to many types of corporate transformation arrangement, this section discusses due diligence in terms of an **acquisition**.

As noted above, an external party in a refinancing or acquisition scenario normally has to rely on the information provided by the other party.

Due diligence is a means of **attesting that information**, normally on behalf of a **prospective bidder**. It can take place at different stages in the negotiations, although the timing is likely to affect the nature of the due diligence process. It may, for example, be pre-acquisition due diligence or it may be retrospective.

There are several different forms of due diligence, some of which are carried out by accountants and financial consultants, while other aspects require the expertise of other specialist skills.

Due diligence will thus attempt to achieve the following:

- Confirm the accuracy of the information and assumptions on which a bid is based
- Provide the bidder with an independent assessment and review of the target business
- Identify and quantify areas of commercial and financial risk
- Give assurance to providers of finance
- Place the bidder in a better position for determining the value of the target company

However, the precise aims will depend on the types of due diligence being carried out.

3.3 Potential liabilities and due diligence

If those involved in due diligence do not act properly there is significant potential for one of the parties to suffer loss as a consequence and **seek legal redress**.

As a general rule, the principle of *caveat emptor* (let the buyer beware) applies. The seller has no general duty to disclose information to the purchaser (there may, however, be a specific contractual duty depending on the terms of the agreement).

Thus auditors and other experts **can be held liable for damages** caused by their failure to uncover potential or actual liabilities or other problems during the due diligence process.

Similarly, the requirements of **corporate governance** could render directors personally liable if adequate due diligence has not been carried out.

3.4 Types of due diligence report

Financial due diligence

Financial due diligence is a review of the target company's **financial position, financial risk and projections**. It is not the same as a statutory audit in a number of ways.

- Its nature, duties, powers and responsibilities are normally determined **bycontract or financial regulation** rather than by statute.
- Its purposes are **more specific** to an individual transaction and to particular user groups.
- There is normally a specific focus on **risk and valuation**.
- Its nature and scope is **more variable from transaction to transaction**, as circumstances dictate, than a statutory audit.
- The information being reviewed is likely to be different and **more future orientated**.
- The **timescale available is likely to be much tighter** than for most statutory audits.

The information which is subject to financial due diligence is likely to include the following:

- Financial statements
- Management accounts
- Projections
- Assumptions underlying projections
- Detailed operating data

- Working capital analysis
- Major contracts by product line
- Actual and potential liabilities
- Detailed asset registers with current sale value/replacement cost
- Debt/lease agreements
- Current/recent litigation
- Property and other capital commitments

Commercial due diligence

Commercial due diligence work complements that of financial due diligence by considering the target company's **markets and external economic environment**.

Information may come from the target company and its business contacts. Alternatively, it may come from external information sources.

Evidence suggests that about half the financial and commercial due diligence for large companies is carried out by accountants. It is important that those carrying out commercial due diligence have a **good understanding of the industry in which the target company operates**.

The information which is relevant to commercial due diligence is likely to include the following:

- Analysis of main competitors
- Marketing history/tactics
- Competitive advantages
- Analysis of resources
- Strengths and weaknesses
- Integration issues
- Supplier analysis
- Market growth expectations
- Ability to achieve forecasts
- Critical success factors
- Key performance indicators
- Exit potential
- Management appraisal
- Strategic evaluation

Such information is useful not only for valuing a target company but also for advance planning of an appropriate post-acquisition strategy.

Operational due diligence

Operational due diligence considers the operational risks and possible improvements which can be made in a target company. In particular it will:

- validate vendor-assumed operational improvements in projections; and
- identify operational upsides that may increase the value of the deal.

The full scope of operations will normally be considered, including the supply chain, logistics and manufacturing. The following areas will typically be considered:

- Procurement costs and cost synergies
- Growth drivers
- Potential risk areas

- Business relationships
- Supplier and distribution channels
- Balance of sales networks
- Inventory levels/flexibility
- Size of operational footprint
- Utilisation of business assets
- Effectiveness of back office functions

Technical due diligence

In many industries the potential for future profitability, and thus the value of the company, may be largely dependent upon developing **successful new technologies**.

A judgement therefore needs to be made as to whether the promised technological benefits are likely to be delivered. This is very common in a whole range of different industries, including electronics, IT, pharmaceuticals, engineering, biotechnology and product development.

Such technological judgements are beyond the scope of accounting expertise, but nevertheless the credibility of technological assumptions may be vital to the valuation process. Reliance will thus need to be placed upon the **work of relevant experts**.

Information technology due diligence

IT due diligence assesses the suitability of and risks arising from **IT factors** in the target company. These risks are likely to be relevant to most companies, but have **particular significance** where the target company operates in the IT sector.

The functions which are relevant to IT due diligence are likely to include the following:

- A risk assessment of embedded systems
- IT security
- Evaluation of synergies, gaps and duplication
- Evaluation of IT compatibility post-acquisition
- IT skills audit
- Process management review
- Post-acquisition rationalisation strategy

Legal due diligence

Legal issues arising on an acquisition are likely to be relevant to the following:

- **Valuation** of the target company – eg, hidden liabilities, uncertain rights, onerous contractual obligations
- The **acquisition process** – eg, establishing the terms of the takeover (the investment agreement); contingent arrangements; financial restructuring; rights, duties and obligations of the various parties
- The **new group** – eg, new articles of association, rights of finance providers, restructuring

Reliance will need to be placed on lawyers for this process.

Human resources due diligence

Protecting and developing the **rights and interests of human resources** may be key to a successful acquisition. There may also be associated **legal obligations**.

The functions which are relevant to HR due diligence are likely to include the following:

- Human resource audit

- Employment contracts review
- Personnel files
- Obligations under the pension scheme
- Training
- Representation and communication policy
- Evaluation of synergies, gaps and duplications in numbers and skills
- Review of potential redundancies and cost savings post-acquisition
- Legal compliance

Tax due diligence

Information will need to be provided to allow the potential purchaser to form an assessment of the **tax risks and benefits** associated with the company to be acquired. Purchasers will wish to assess the robustness of tax assets, and gain comfort about the position re potential liabilities (including a possible latent gain on disposal due to the low base cost).

- An explanation of the reason for the disposal structure, including an analysis of the base cost position and a full technical analysis of the tax position (eg, degrouping charges, transfer of losses)
- Corporation tax reference details
- Copies of all previous tax computations, agreed and submitted
- Copies of correspondence with tax authorities on corporation tax and VAT
- Details and proof of pre-disposal VAT grouping position
- Details of corporation tax group payment arrangements
- Details of any transactions with connected parties outside of Bangladesh
- Details of payroll arrangements, plus copies of relevant correspondence

Information re **tax warranties** that the vendor might offer should also be made available with the due diligence report as part of the 'marketing' information. This should generally not form a part of the due diligence itself though.

Professional skills focus: Structuring problems and solutions

Working your way methodically through the various types of due diligence required (such as financial, operational and even legal) will ensure that the work you do is thorough and does not overlook any hidden issues for your client.

3.5 Warranties

Due diligence may not be able to answer all the questions of the buyer. Warranties are therefore usually given by the sellers of the company as a **type of insurance**. If the warranties are breached the buyer may be able to claw back some of the sale proceeds. The specific nature of the warranties will depend on the individual circumstances; however, they may include the following:

- All details regarding contracts of employment have been disclosed.
- Sales contracts exist and are current.
- All contingent liabilities have been disclosed.
- Tax has been paid or accrued for.

Interactive question 3: Due diligence

Hill Ltd is in the process of acquiring Lee Ltd, a contract cleaning business. The accountants are performing the due diligence and have identified the following issues:

(1) They have been unable to obtain the personnel files and employment contracts of two sales managers.

(2) They have been unable to review the service contract with one of Lee Ltd's major customers.

(3) The finance director does not own any shares in Lee Ltd and has indicated that he is unwilling to sign any warranties.

Requirement

Explain the implications of 1 to 3 above.

See **Answer** at the end of this chapter.

4 Reporting on prospective financial information (PFI)

Section overview

- Prospective financial information (PFI) includes forecasts and projections.
- It is difficult to give assurance about PFI because it is highly subjective.
- Procedures could include:
  - analytical procedures
  - verification of projected expenditure to quotes or estimates
- An opinion may be given in the form of negative assurance.

4.1 Introduction

Prospective financial information means financial information based on **assumptions about events that may occur in future and possible actions by an entity**.

PFI can be of two types (or a combination of both):

A forecast: PFI based on assumptions as to future events which management expects to take place and the actions management expects to take (best-estimate assumptions).

A projection: PFI based on hypothetical assumptions about future events and management actions, or a mixture of best-estimate and hypothetical assumptions.

Increasingly, company directors are producing PFI, either voluntarily or because it is required by regulators, for example, in the case of a public offering of shares.

Markets and investors need PFI that is **understandable, relevant, reliable and comparable**. Some would say that PFI is of **more interest** to users of accounts than historical information which, of course, auditors do report on in the statutory audit. It is highly subjective in nature and its preparation requires the **exercise of judgement**.

This is an area, therefore, in which the auditors can provide an alternative service to audit, in the form of a review or assurance engagement.

Reporting on PFI is covered by ISAE 3400, *The Examination of Prospective Financial Information*.

4.2 Accepting an engagement

ISAE 3400 states that the auditor should **agree the terms of the engagement** with the directors, and should withdraw from the engagement if the assumptions made to put together the PFI are unrealistic. It also lists the following factors which the auditor should consider:

- The intended use of the information
- Whether the information will be for general or limited distribution
- The nature of the assumptions; that is, whether they are best estimate or hypothetical assumptions
- The elements to be included in the information
- The period covered by the information

The auditor should have **sufficient knowledge** of the business to be able to evaluate the significant assumptions made.

A firm must also consider practical matters, such as the time available to them, their experience of the staff member compiling the information, any limitations on their work and the degree of secrecy required beyond the normal duty of confidentiality.

4.3 Procedures

When determining the nature, timing and extent of procedures, the auditor should consider the following:

- The likelihood of material misstatement
- The knowledge obtained during any previous engagements
- Management's competence regarding the preparation of PFI
- The extent to which PFI is affected by the management's judgement
- The adequacy and reliability of the underlying data

The auditor should obtain sufficient appropriate evidence as to whether:

(a) management's best-estimate assumptions on which the PFI is based are **not unreasonable** and, in the case of hypothetical assumptions, such assumptions are **consistent** with the purpose of the information;

(b) the PFI is **properly prepared** on the basis of the assumptions;

(c) the PFI is **properly presented** and all material assumptions are adequately disclosed, including a clear indication as to whether they are best-estimate assumptions or hypothetical assumptions; and

(d) the PFI is prepared on a **consistent basis with historical financial statements**, using appropriate accounting principles.

4.4 Specific procedures

The key issues which projections relate to are **profits, capital expenditure and cash flows**. The following list of procedures provides examples of procedures which may also be relevant when assessing PFI. The auditor should undertake the review of procedures discussed above in addition to these.

Profit forecasts

(a) Verify projected income figures to suitable evidence. This may involve:

    (1) comparison of the basis of projected income to similar existing projects in the firm; or

    (2) review of current market prices for that product or service; that is, what competitors in the market charge successfully.

(b) Verify projected expenditure figures to suitable evidence. There is likely to be more evidence available about expenditure in the form of:
   (1) quotations or estimates provided to the firm;
   (2) current bills for things such as services which can be used to reliably estimate market rate prices, for example, for advertising;
   (3) interest rate assumptions can be compared to the bank's current rates; and
   (4) costs such as depreciation should correspond with relevant capital expenditure projections.

Capital expenditure

The auditor should check the capital expenditure for reasonableness. For example, if the projection relates to buying land and developing it, it should include a sum for land.

(a) Projected costs should be verified to estimates and quotations, where possible.
(b) The projections can be reviewed for reasonableness, including a comparison of prevailing market rates where such information is available (such as for property).

Cash forecasts

(a) The auditors should review cash forecasts to ensure the timings involved are reasonable (for example, it is not reasonable to say the building will be bought on day 1, as property transactions usually take longer than that).
(b) The auditor should check the cash forecast for consistency with any profit forecasts (income/expenditure should be the same, just at different times).
(c) If there is no comparable profit forecast, the income and expenditure items should be verified as they would have been on a profit forecast.

4.5 Expressing an opinion

It is clear that as PFI is subjective information, it is impossible for an auditor to give the same level of assurance regarding it, as they would on historical financial information. In this instance, the limited assurance is expressed in a **negative form**.

The ISAE suggests that the auditor express an opinion including the following:

- A statement of negative assurance as to whether the assumptions provide a reasonable basis for the PFI
- An opinion as to whether the PFI is properly prepared on the basis of the assumptions and the relevant reporting framework
- Appropriate caveats as to the achievability of the forecasts

In accordance with ISAE 3400 the report by an auditor on an examination of prospective financial information should contain the following:

- Title
- Addressee
- Identification of the PFI
- A reference to the ISAE or relevant national standards or practices applicable to the examination of PFI
- A statement that management is responsible for the PFI including the assumptions on which it is based
- When applicable, a reference to the purpose and/or restricted distribution of the PFI
- A statement of negative assurance as to whether the assumptions provide a reasonable basis for the PFI

- An opinion as to whether the PFI is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework
- Appropriate caveats concerning the achievability of the results indicated by the PFI
- Date of the report which should be the date procedures have been completed
- Auditor's address
- Signature

Example of an extract from an unmodified report on a forecast

We have examined the forecast in accordance with the International Standard on Assurance Engagements applicable to the examination of prospective financial information. Management is responsible for the forecast including the assumptions set out in note X on which it is based.

Based on our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us to believe that these assumptions do not provide a reasonable basis for the forecast. Further, in our opinion the forecast is properly prepared on the basis of the assumptions and is presented in accordance with ....

Actual results are likely to be different from the forecast since anticipated events frequently do not occur as expected and the variation may be material.

When the auditor believes that the presentation and disclosure of the PFI is not adequate, the auditor should express a **qualified or adverse opinion** (or withdraw from the engagement).

When the auditor believes that one or more significant assumptions do not provide a reasonable basis for the PFI, the auditor should **express an adverse opinion** (or withdraw from the engagement).

When there is a scope limitation the auditor should either withdraw from the engagement or disclaim the opinion.

Professional skills focus: Concluding, recommending and communicating

Reports on PFI require strong communication skills to explain the difference between the limited assurance given on the assumptions used in the forecast and the reasonable assurance given on the preparation of the forecast based on those assumptions.

Interactive question 4: Prospective financial information

A new client of your practice, Peter Lawrence, has recently been made redundant. He is considering setting up a residential home for old people, as he is aware that there is an increasing need for this service with an ageing population (more people are living to an older age). He has seen a large house, which he plans to convert into an old people's home. Each resident will have a bedroom, there will be a communal sitting room and all meals will be provided in a dining room. No long-term nursing care will be provided, as people requiring this service will either be in hospital or in another type of accommodation for old people.

The large house is in a poor state of repair, and will require considerable structural alterations (building work), and repairs to make it suitable for an old people's home. The following will also be required:

- New furnishings (carpets, beds, wardrobes and so on for the residents' rooms; carpets and furniture for the sitting room and dining room)

- Decoration of the whole house (painting the woodwork and covering the walls with wallpaper)
- Equipment (for the kitchen and for helping disabled residents)

Mr Lawrence and his wife propose to work full time in the business, which he expects to be available for residents six months after the purchase of the house. Mr Lawrence has already obtained some estimates of the conversion costs, and information on the income and expected running costs of the home.

Mr Lawrence has received about £50,000 from his redundancy. He expects to receive about £130,000 from the sale of his house (after repaying his mortgage). The owners of the house he proposes to buy are asking £250,000 for it, and Mr Lawrence expects to spend £50,000 on conversion of the house (building work, furnishing, decorations and equipment).

Mr Lawrence has prepared a draft capital expenditure forecast, a profit forecast and a cash flow forecast which he has asked you to check before he submits them to the bank, in order to obtain finance for the old people's home.

Requirements

Describe the procedures you would carry out on:

(a) The capital expenditure forecast

(b) The profit forecast

(c) The cash flow forecast

See **Answer** at the end of this chapter.

5 Agreed-upon procedures

Section overview

- The terms of the engagement must be clearly defined.
- The procedures conducted will depend on the nature of the engagement.
- No assurance is given. The report identifies the practitioner's findings.

5.1 Objective

Agreed-upon procedures assignments use International Standard on Related Services – in this case ISRS 4400 (Revised), *Agreed-Upon Procedures Engagements* which was issued by IAASB in April 2020.

In an engagement to perform agreed-upon procedures, a practitioner is engaged to carry out procedures that have been agreed between the practitioner and the engaging party (and if relevant, other parties) and to report on the procedures performed and any related findings. The recipients of the report **must draw their own conclusions** from the report produced by the practitioner. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the results.

Agreed-upon procedures are sometimes referred to as AUP. They could include anything agreed between the practitioner and the engaging party including information, documents, measurements or even compliance with laws and regulations. Subject matter could be of a

financial nature (such as the eligibility of expenditure to be claimed as part of the funding arrangements of a grant) or **non- financial nature** (such as the observation of the destruction of items as required to be reported to a regulatory authority).

5.2 Defining the terms of the engagement

ISRS 4400 (Revised) states that the practitioner should **agree the terms of the AUP with the engaging party and record them in an engagement letter or other equivalent written agreement**. Matters to be agreed should include the following:

- The subject matter on which the AUP will be performed
- The stated purpose and the intended users of the AUP report
- Acknowledgement of appropriate ethical and independence requirements
- Nature, timing and extent of the specific procedures to be applied
- Acknowledgement by all relevant parties that AUP work is appropriate under the circumstances
- Identification of the addressee of the AUP report and the expected form and content of the report

Professional skills focus: Assimilating and using information

You will need to make sure you read the scenario carefully if agreed-upon procedures are being considered. Have you taken everything into consideration when determining what this work will require?

5.3 Procedures

The **procedures performed** will depend upon the terms of the engagement. The ISRS states that if any additional expertise is required (in other words, **a practitioner's expert**) their competence, capabilities and objectivity should be evaluated and their work assessed to ensure it is consistent with the terms of the engagement.

5.4 Reporting

The report of factual findings should contain the following:

- A title that clearly identifies the work as an AUP engagement
- Addressee to reflect what was agreed in the terms of the engagement
- Identification of specific subject matter on which the AUP are performed (plus an acknowledgement that the AUP report may not be suitable for any other purpose)
- When relevant, a statement that the practitioner is not independent of the entity but that in any event, the practitioner has complied with IESBA Code
- Acknowledgement that ISQC 1 was followed
- A listing of the specific procedures performed
- A description of the practitioner's findings including sufficient details of any exceptions found
- A statement that the procedures performed do not constitute either an audit or a review and, as such, no assurance is expressed
- A statement that had the practitioner performed additional procedures, an audit or a review, other matters might have come to light that would have been reported

- Date of the report
- Practitioner's address
- Practitioner's signature

Notes

1 **No assurance is expressed**. The practitioner only reports their **findings**.

2 This standard was issued prior to the adoption of the quality management standards in 2021 when ISQC 1 and the terms 'quality control' and 'engagement quality control review' were still in use – however, in this instance you can assume that these practices are referring to what you understand to be quality management and engagement quality reviews respectively under ISQM 1.

Appendix 2 of ISRS 4400 (Revised) includes the following example of an AUP report:

Example of Agreed-Upon Procedures Report on Procurement of [XYZ] Products

To [Addressee]

Purpose of this Agreed-Upon Procedures Report

Our report is solely for the purpose of assisting [Engaging Party] in determining whether its procurement of [xyz] products is compliant with its procurement policies and may not be suitable for another purpose.

Responsibilities of the Engaging Party and the Responsible Party

[Engaging Party] has acknowledged that the agreed-upon procedures are appropriate for the purpose of the engagement.

[Responsible Party], as identified by [Engaging Party], is responsible for the subject matter on which the agreed-upon procedures are performed.

Practitioner's responsibilities

We have conducted the agreed-upon procedures engagement in accordance with the International Standard on Related Services (ISRS) 4400 (Revised), *Agreed-Upon Procedures Engagements*. An agreed-upon procedures engagement involves our performing the procedures that have been agreed with [Engaging Party], and reporting the findings, which are the factual results of the agreed-upon procedures performed. We make no representation regarding the appropriateness of the agreed-upon procedures.

This agreed-upon procedures engagement is not an assurance engagement. Accordingly, we do not express an opinion or an assurance conclusion.

Had we performed additional procedures, other matters might have come to our attention that would have been reported.

Professional ethics and quality control

We have complied with the ethical requirements in [describe the relevant ethical requirements]. For the purpose of this engagement, there are no independence requirements with which we are required to comply.

Our firm applies International Standard on Quality Management 1, which requires the firm to design, implement and operate a system of quality management including policies or procedures regarding compliance with ethical requirements, professional standards and applicable legal and regulatory requirements.

(a) Obtain from management of [Responsible Party] a listing of all contracts signed between [January 1, 20X1] and [December 31, 20X1] for [xyz] products ("listing") and identify all contracts valued at over $25,000.

(b) For each identified contract valued at over $25,000 on the listing, compare the contract to the records of bidding and determine whether the contract was subject to bidding by at least 3 contractors from [Responsible Party]'s "pre-qualified contractors list".

(c) For each identified contract valued at over $25,000 on the listing, compare the amount payable per the signed contract to the amount ultimately paid by [Responsible Party] to the contractor and determine whether the amount ultimately paid is within $100 of the agreed amount in the contract.

Findings

(a) We obtained from management a listing of all contracts for [xyz] products which were signed between [January 1, 20X1] and [December 31, 20X1]. Of the 125 contracts on the listing, we identified 37 contracts valued at over $25,000.

(b) We inspected the records of bidding related to the 37 contracts valued at over $25,000. We found that all of the 37 contracts were subject to bidding by at least 3 contractors from the [Responsible Party]'s "pre-qualified contractors list".

(c) We obtained the signed contracts for the 37 contracts valued at over $25,000 on the listing and compared the amounts payable in the contracts to the amounts ultimately paid by [Responsible Party] to the contractor. We found that the amounts paid were within $100 of the agreed amounts in all of the 37 contracts with no exceptions noted.

[Practitioner's signature]

[Date of practitioner's report]

[Practitioner's address]

6 Compilation engagements

Section overview

- A compilation engagement is one in which the accountant compiles information.
- The information must contain a reference making it clear that it has not been audited.
- No assurance is expressed on the financial information.

6.1 Compilations

In a compilation engagement, the accountant is engaged to use **accounting expertise**, as opposed to auditing expertise, to collect, classify and compile financial information.

Definition

Compilation engagement: An engagement in which a practitioner applies accounting and financial reporting expertise to help management with the preparation and presentation of financial information of an entity in accordance with an applicable financial reporting framework, and reports as required by the relevant ISRS.

Examples include preparation of:

- historical financial information;
- pro forma financial information; and
- prospective financial information including financial budgets and forecasts.

The international guidance on compilation engagements is found in ISRS 4410 (Revised), *Compilation Engagements*. The IAASB issued a revised ISRS in March 2012. This resulted from the growing demand from small and medium-sized enterprises (SMEs) for services other than audit, particularly in jurisdictions where exemptions for certain entities from the requirement to have an audit have been introduced.

Conforming amendments have been made to ISRS 4410 (Revised) resulting from the changes made to ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* by the IAASB following the conclusion of its NOCLAR (non-compliance with laws and regulations) project.

In particular these amendments provide guidance regarding the reporting of identified or suspected non-compliance with laws and regulations to an appropriate authority outside the entity.

This may be appropriate for reasons we discussed earlier.

In some instances reporting to authorities outside the entity may give rise to confidentiality issues. The practitioner may consult internally, obtain legal advice or consult with a regulator or professional body in order to understand the implications of different courses of action.

6.2 Procedures

6.2.1 Engagement acceptance

In accordance with the revised ISRS, the work must be carried out in accordance with ethical and quality management requirements. The practitioner must agree the terms of the engagement, in an engagement letter or other suitable form of written agreement, with the management or the engaging party if different including the following:

(a) The intended use and distribution of the financial information, and any restrictions on its use or distribution

(b) Identification of the applicable financial reporting framework

(c) The objective and scope of the engagement

(d) The responsibilities of the practitioner, including the requirement to comply with relevant ethical requirements

(e) The responsibilities of management for the financial information, the accuracy and completeness of the records and documents provided by management for the compilation engagement and the judgements needed in the preparation and presentation of the financial information

(f) The expected form and content of the practitioner's report

6.2.2 Performing the engagement

The practitioner is required to obtain an understanding of the entity's business and operations including the accounting system and accounting records and the applicable financial reporting framework. The practitioner then compiles the information using the records, documents, explanations and other information provided by management. The specific nature of the work will depend on the nature of the engagement. Before completion the practitioner must read the compiled information in the light of the understanding obtained of the entity's business and operations and the applicable financial reporting framework. If the practitioner becomes aware that the information provided by management is incomplete, inaccurate or otherwise unsatisfactory the practitioner must bring this to the attention of management and request additional or corrected information. If management fail to provide this information and the engagement cannot be completed or management refuse to make amendments proposed by the practitioner, the practitioner must withdraw from the engagement and inform management and those charged with governance.

The practitioner must obtain an acknowledgement from management or those charged with governance that they take responsibility for the final version of the information.

6.3 Reporting

The practitioner's report must clearly communicate the nature of the compilation engagement. ISRS 4410 (Revised) stresses that the report is not a vehicle to express an opinion or conclusion on the financial information in any form. The report on a compilation engagement must be in writing and must contain the following:

- Title
- Addressee
- A statement that the practitioner has compiled the financial information based on information provided by management
- A description of the responsibilities of management, or those charged with governance in relation to the compilation engagement
- Identification of the applicable financial reporting framework and, if a special purpose financial reporting framework is used, a description or reference to the description of that special purpose financial reporting framework in the financial information
- Identification of the financial information, including the title of each element of the financial information (if it comprises more than one element) and the date of the financial information
- A description of the practitioner's responsibilities in compiling the financial information, including that the engagement was performed in accordance with ISRS 4410 (Revised) and that the practitioner has complied with relevant ethical requirements

- A description of what a compilation engagement entails
- Explanation that as the compilation engagement is not an assurance engagement, the practitioner is not required to verify the accuracy or completeness of the information provided by management for the compilation
- Explanation that the practitioner does not express an audit opinion or a review conclusion on whether the financial information is prepared in accordance with the applicable financial reporting framework
- If the financial information is prepared using a special purpose framework an explanatory paragraph that describes the purpose of the financial information and the intended users and draws the readers' attention to the fact that the information may not be suitable for other purposes
- Date of the report
- Practitioner's address
- Practitioner's signature

Appendix 2 of ISRS 4410 (Revised) contains a number of examples of a compilation report. The following extract is based on Illustration 1.

Example of a Report on an Engagement to Compile Financial Statements

PRACTITIONER'S COMPILATION REPORT

[To Management of ABC Company]

We have compiled the accompanying financial statements of ABC Company based on information you have provided. These financial statements comprise the statement of financial position of ABC Company as at December 31, 20X1, the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

We performed this compilation engagement in accordance with International Standard on Related Services 4410 (Revised), *Compilation Engagements*.

We have applied our expertise in accounting and financial reporting to help you with the preparation and presentation of these financial statements in accordance with International Financial Reporting Standards for Small and Medium-sized Entities (IFRS for SMEs). We have complied with relevant ethical requirements, including the principles of integrity, objectivity, professional competence and due care.

These financial statements and the accuracy and completeness of the information used to compile them are your responsibility.

Since a compilation engagement is not an assurance engagement, we are not required to verify the accuracy or completeness of the information you provided to us to compile these financial statements. Accordingly, we do not express an audit opinion or a review conclusion on whether these financial statements are prepared in accordance with IFRS for SMEs.

7 Forensic audit

Section overview

Forensic auditing can be applied to a wide variety of situations, including fraud and negligence investigations.

7.1 Introduction

Definitions

Forensic auditing: The process of gathering, analysing and reporting on data, in a predefined context, for the purpose of finding facts and/or evidence in the context of financial or legal disputes and/or irregularities and giving preventative advice in this area.

Forensic investigation: Undertaking a financial investigation in response to a particular event, where the findings of the investigation may be used as evidence in court or to otherwise help resolve disputes.

Forensic investigations are carried out for civil or criminal cases. These can involve fraud or money laundering.

Forensic audit and accounting is a rapidly growing area. The major accountancy firms all offer forensic services, as do a number of specialist companies. The demand for these services arises partly from the increased corporate governance focus on company directors' responsibilities for the prevention and detection of fraud, and partly from government concerns about the criminal funding of terrorist groups.

Context example: Forensic accounting

The range of assignments in this area is vast, so to give specific definitions for each is not always practicable. As an illustration, the ICAEW website explains what you can expect if you choose a career working in forensic accounting:

"Forensic accountants use their expertise in finance to investigate fraud and other financial misrepresentation. They work analysing financial information to enable lawyers to prosecute criminals, such as those funding illegal activities, and with insurance companies and other clients to resolve disputes."

"Forensic accountants are trained to look beyond the numbers and deal with the business realities of situations. This enables them to identify criminal activities, such as money laundering activities and the illegal sale of arms."

"Analysis, interpretation, summarisation and the presentation of complex financial and business related issues are prominent features of the profession."

"A forensic accountant will be familiar with legal concepts and procedures, and must be able to communicate financial information clearly and concisely in the courtroom."

(Source: ICAEW (n.d.) *A career in forensic accounting*. [Online]. Available from: https://careers.icaew.com/why-a-career-in-chartered-accountancy/the-work-you-can-do/forensic- accounting [Accessed 7 October 2022])

7.2 Applications of forensic auditing

7.2.1 Fraud

Forensic accountants can be engaged to investigate fraud. This could involve:

- quantifying losses from theft of cash or goods;
- identifying payments or receipts of bribes;
- identifying intentional misstatements in financial information, such as overstatement of revenue and earnings and understatement of costs and expenses; or
- investigating intentional misrepresentations made to auditors.

Forensic accountants may also be engaged to act in an advisory capacity, to help directors with developing more effective controls to reduce the risks from fraud.

7.2.2 Negligence

When an auditor or accountant is being sued for negligence, either or both parties to the case may employ forensic accountants to investigate the work done to provide evidence as to whether it did in fact meet the standards required. They may also be involved in establishing the amount of loss suffered by the plaintiff.

7.2.3 Insurance claims

Insurance companies often employ forensic accountants to report on the validity of the amounts of losses being claimed, as a means of resolving the disputes between the company and the claimant.

This could involve computing losses following an insured event such as a fire, flood or robbery. If a criminal action arises over an allegation that an insured event was deliberately contrived to defraud the insurance company, the forensic accountant may be called upon as an expert witness (see section 7.2.6 below).

7.2.4 Other disputes

Forensic accountants can be involved in the investigation of many other types of dispute:

- Shareholder disputes
- Partnership disputes
- Contract disputes
- Business sales and purchase disputes
- Matrimonial disputes, including:
  - valuing the family business
  - gathering financial evidence
  - identifying 'hidden' assets
  - advising in settlement negotiations

7.2.5 Terrorist financing

Governments are increasingly turning to forensic accountants as part of their counterterrorism strategy.

Gordon Brown, who was the UK Chancellor of the Exchequer at the time, said in a speech in October 2006:

[…] forensic accounting of transaction trails across continents has been vital in identifying threats, uncovering accomplices, piecing together company structures, and ultimately providing evidence for prosecution. Most recently, forensic accounting techniques have tracked an alleged terrorist bomb maker, using multiple identities, multiple bank accounts and third parties and third world countries to purchase bomb making equipment and tracked him to and uncovered an overseas bomb factory.

7.2.6 The forensic accountant as expert witness

The preceding sections have identified a number of circumstances where the forensic accountant may be involved as an expert witness in civil or criminal cases. For civil cases in England and Wales, the duties of expert witnesses are set out in the **Civil Procedure Rules**.

(a) Experts always owe a duty to **exercise reasonable skill and care** to those instructing them, and to comply with any relevant professional code of ethics.

However, as expert witnesses in civil proceedings, they have an **overriding duty to help the court** on matters within their expertise.

(b) Experts should be aware of the overriding objective that courts deal with cases **justly**. Experts are under an obligation to help the court so as to enable them to deal with cases in accordance with the overriding objective.

However, experts have no obligations to act as mediators between the parties or require them to trespass on the role of the court in deciding facts.

(c) Experts should provide opinions which are **independent**, regardless of the pressures of litigation. In this context, a useful test of 'independence' is that the expert would express the same opinion if given the same instructions by an opposing party. Experts should not take it upon themselves to promote the point of view of the party instructing them or engage in the role of **advocates**.

(d) Experts should confine their opinions to matters which are **material to the disputes** between the parties and provide opinions only in relation to matters which lie **within their expertise**. Experts should indicate without delay where particular questions or issues fall outside their expertise.

7.3 Procedures and evidence

7.3.1 Planning

The broad process of conducting a forensic audit bears some similarity to an audit of financial statements, in that it will include a planning stage, a period when evidence is gathered, a review process, and a report to the client. However, forensic investigations are not all of the same sort, and it is essential that the investigation team considers carefully exactly what it is that they have been asked to achieve in this particular investigation, and that they plan their work accordingly. Professional judgement will be required to do the following:

- Identify the objectives of the engagement
- Obtain sufficient understanding of the circumstances and events surrounding the engagement
- Obtain sufficient understanding of the context within which the engagement is to be conducted (eg, any relevant laws or regulations)
- Identify any limitation on the scope of the engagement (eg, where information is not available)
- Evaluate the resources necessary to complete the work, and identify a suitable engagement team

In order to meet these requirements, the engagement plan should include the following.

- Develop hypotheses to address the circumstances and context of the engagement
- Decide on the best approach to meet the engagement objectives within constraints such as cost and time

- Identify the financial (and other) information needed, and develop a strategy to acquire it
- Determine the impact of the nature and timing of any reporting requirements

One key difference in emphasis from an audit of financial statements is that the forensic accountant is stepping into an arena that is defined by conflict. It is thus essential that the investigator obtains an understanding of the background and context to the engagement as well as of any limitations on its scope, as these will affect the extent of the conclusions that can be drawn. In the case of a matrimonial dispute, for example, the investigator would need to take a sceptical attitude towards all the information they are provided with, as it may be biased, false or incomplete.

Many forensic investigations involve investigating potential frauds. The objectives of a fraud investigation would include the following:

- Identifying the type of fraud that has been operating, how long it has been operating for, and how the fraud has been concealed
- Identifying the fraudster(s) involved
- Quantifying the financial loss suffered by the client
- Gathering evidence to be used in court proceedings
- Providing advice to prevent the recurrence of the fraud

The investigators should then consider the best way to gather evidence in the light of these objectives.

7.3.2 Audit procedures

The specific procedures which would be performed as part of a forensic audit will depend on the specific nature of the investigation. However, using a fraud investigation as an example, the following would normally apply.

- Develop a profile of the entity under investigation including its personnel
- Identify weaknesses in internal control procedures and basic recordkeeping eg, bank reconciliations not performed
- Perform trend analysis and analytical procedures to identify significant transactions and significant variations from the norm
- Identify changes in patterns of purchases/sales, particularly where a limited number of suppliers/customers are involved
- Identify significant variations in consumption of raw materials and consumables, particularly where consumption appears excessive
- Identify unusual accounts and account balances eg, closing credit balances on debit accounts and vice versa
- Review accounting records for unusual transactions and entries, eg, large numbers of accounting entries between accounts, transactions not executed at normal commercial rates
- Review transaction documentation (eg, invoices) for discrepancies and inconsistencies
- Once identified trace the individual responsible for fraudulent transactions
- Obtain information regarding all responsibilities of the individual involved
- Inspect and review all other transactions of a similar nature conducted by the individual
- Consider all other aspects of the business which the individual is involved with and perform further analytical procedures targeting these areas to identify any additional discrepancies

Interactive question 5: Forensic auditing

You are a manager in the forensic investigation department of an audit firm. The financial director of Benji Co approached you with a request to investigate a fraud. He has identified a number of discrepancies between inventory records and the half-year physical inventory counts which are performed. Furthermore, the discrepancy always relates to the same product line and approximately the same number of items appear to be missing each time.

Requirement

Explain the procedures you would perform to determine whether a fraud has taken place and to quantify the loss suffered by the company.

See **Answer** at the end of this chapter.

7.3.3 A different approach

While many of the techniques used in a forensic investigation will be similar to those used in an audit, the different objectives and risks involved will require some differences in approach.

Materiality	There may be no materiality threshold.
Timing	Less predictable than audit – often by necessity.
Documentation	Needs to be reviewed more critically than on an audit.
Interviews	It may be appropriate to interview a suspected fraudster. Doing so requires a high level of experience and skill, and awareness of legal issues (including risk of prosecution for defamation).
Computer-assisted techniques	Data mining is key to many investigation processes, allowing the accountant to access and analyse large numbers of transactions. Specific characteristics can be checked ie, date, time, amount, approval, payee. If possible, data should be gathered before the initial field visit to reduce the risk of the data being compromised.

Summary

Assurance

Prior knowledge

- Concept of assurance
- Elements of engagement
- Planning

Types of assurance engagement and related

- Review of financial statements
- Due diligence
- Reports on prospective financial information
- Agreed-upon procedures
- Compilation engagements

Types of due diligence

- Financial
- Commercial
- Operational
- Technical
- Information technology
- Legal
- Human resources
- Forensic audits

Forensic audits:

- Fraud
- Negligence
- Insurance claims
- Other disputes
- Terrorist financing

Common elements of assurance engagements

- Prior knowledge
- Procedures required
- Conclusions
- Reporting

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Can you explain what assurance is and when you might be required to report using different extents of assurance?
2.	Could you advise a client of the differences between an audit and a review of a set of financial statements?
3.	Do you understand the various types of due diligence and can you explain why each would be required?
4.	Are you comfortable working your way through a forecast and interrogating each line to make sure you understand all the relevant assumptions?
5.	Do you know what agreed-upon procedures are and when you might use them?
6.	Can you explain what a firm would do if asked to perform a compilation engagement?
7.	Do you know what forensic auditing means and can you name some examples of the type of work it might include?

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Travis plc	This is a great opportunity to interrogate a limited scenario and consider how due diligence would apply in a practical setting.
Upstarts Ltd	This is much more challenging and illustrates how you might be asked to consider assurance work in the context of other responsibilities for the same client and what you should do in response.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios that will help you improve your knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Precision Garage Access requirement (2)	You can see from this question that certain key financial reporting issues may be present for companies that create interim financial statements, so use this as experience of how this might be examined.
KK requirement (3)	To illustrate the integrated nature of this exam, this is a good way of showing how content from this chapter could be tested in a larger scenario.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries.

Once you have attempted these questions, you can continue your studies by moving on to the next chapter.

Technical reference

1 Assurance engagements

- Planning – **ISAE 3000.40-45**
- Obtaining evidence – **ISAE 3000.48-51**
- Reporting – **ISAE 3000.67-77**

2 Assurance reports at service organisations

- Objectives – **ISAE 3402.8**
- Reporting – **ISAE 3402.53-55**

3 Assurance engagements on greenhouse gas statements

- Objective – **ISAE 3410.13**
- Reporting – **ISAE 3410.76 & Appendix 2**

4 Review of historical financial information

- Nature – **ISRE 2400.5-8**
- Quality control – **ISRE 2400.24-25**
- Agreeing terms – **ISRE 2400.37**
- Procedures – **ISRE 2400.43-57**
- Reporting – **ISRE 2400.86-92 & Illustrations**

5 Review of interim financial information

- Assurance provided – negative – **ISRE 2410.7**
- Procedures – **ISRE 2410.12-29**
- Reporting – **ISRE 2410.43-63 & Appendices 5, 6 and 9**

6 Prospective financial information

- Acceptance – **ISAE 3400.10-12**
- Procedures – **ISAE 3400.17-25**
- Reporting – **ISAE 3400.27-33**

7 Agreed-upon procedures

- Defining the terms – **ISRS 4400 (Revised).24**
- Subject matter – **ISRS 4400 (Revised).A1-2**
- Reporting – **ISRS 4400 (Revised).30 & Appendix 2**

8 Compilation engagements

- Defining terms – **ISRS 4410.17**
- Procedures – **ISRS 4410.28-37**
- Reporting – **ISRS 4410.39-41 & Appendix**

Self-test questions

Answer the following questions

1 Travis plc

Travis plc is an international hotel company which is looking to expand and diversify via acquisition. Two potential target companies have been identified.

(1) Bandic AB operates over 100 hotels throughout Scandinavia, an area where Travis plc currently has no hotel. This acquisition would give it a fast entry into this new geographical market. Approximately half of Bandic AB's hotels target the luxury/business end of the market, where Travis plc currently focuses; the remainder are more downmarket.

(2) Macis plc has several hotels throughout the British Isles with a high proportion in Scotland, where Travis plc currently has only limited coverage. So far Travis plc has acquired 4% of the share capital of Macis plc in several relatively small purchases.

Requirements

1.1 If the acquisition of Bandic AB is to go ahead, explain four key business risks the directors should consider.

1.2 Explain the purpose of a due diligence exercise if one of these purchases were to go ahead.

2 Upstarts Ltd

You are a senior in the corporate services department of your firm which has been approached by GP Sidney Wittenburg Global Fund Managers (GPSWGFM), the venture capital arm of a leading investment bank. GPSWGFM is investigating a management buy-out (MBO) of Upstarts Ltd (Upstarts).

Upstarts was formed as a start-up three years ago, as a wholly owned subsidiary of an IT hardware supplier, DatLinks plc (DatLinks). DatLinks and Upstarts both operate entirely within the UK. The group's accounting year end is 30 September. Upstarts provides a 'one stop service' for client extranets to the financial services industry (ie, intranets which can be securely accessed by customers to obtain information, pay bills etc). Upstarts provides hardware, which is sourced exclusively from its parent company DatLinks, plus software, support, web design and security services.

It was initially successful, but some highly publicised problems surrounding security breaches in similar products, together with cash flow problems, have resulted in a severe breakdown in the relationship between Upstarts's management team and the directors of DatLinks. DatLinks is therefore keen to divest itself of its interest in Upstarts.

The proposed deal would involve GPSWGFM providing the funding for the MBO. Its exit route will be via a planned flotation of Upstarts in two to four years' time. GPSWGFM has worked with Upstarts's management to produce a detailed business plan and financial projections up to the date of the flotation under a variety of scenarios.

Your firm has been asked to quote for the full range of advisory services, including the following:

- Due diligence on the MBO
- Review of the business plan and the financial projections
- Tax structuring advice on the acquisition
- Upstarts's audit and advisory work on an ongoing basis
- Advisory work on the planned flotation of Upstarts

Performance management

The gross assets of Upstarts are £9.5 million. The acquisition price is estimated at this stage to be in the region of £45 million, although this will depend on the outcome of the due diligence work and the review of the financial projections.

GPSWGFM informs you that the price looks very attractive, since it is based upon historical earnings levels which have been depressed by DatLinks's group accounting policies. Discussions with Upstarts's management team have revealed that the vendor group's transfer pricing policies had the effect of reducing the results of its subsidiaries and inflating the results of the parent. Upstarts's finance director has provided GPSWGFM with revised financial statements, together with detailed reconciliations which reverse the effects of these policies and restate Upstarts's historical results on a 'standalone' basis. These would indicate a true market value in the region of £60 million.

GPSWGFM believes that, in addition to an early cash injection, the success of Upstarts depends upon the retention of its key asset – the design team. The deal depends upon the retention of up to 25 identified individuals, at least until GPSWGFM's exit on flotation. To this end, and to protect its investment, GPSWGFM wishes to grant share options, with current values per employee ranging from £50,000 to £100,000, to be exercisable in two to four years' time – depending on how quickly the flotation takes place. The poor relationship between the management teams of Upstarts and DatLinks means that access to DatLinks's management team during the due diligence process will be restricted. A data room containing detailed financial, legal and commercial information will be provided at the premises of DatLinks's lawyers. Upstarts's management team will, however, be freely available to answer questions and provide any information that might be requested. DatLinks has indicated that it will not provide any warranties in respect of the acquisition.

The engagement partner from your firm is meeting GPSWGFM shortly to discuss the potential assignment. He has asked you to provide him with a briefing note that will assess the risks associated with the assignment including the due diligence, the business plan review and the ongoing audit.

Requirement

Prepare the briefing note for the engagement partner.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

1.1 Investors will be concerned about risk management, as the risk that the company enters into has a direct impact on the risk of the investment. Stakeholders need assurance that the risk taken by the company is acceptable to them and that the returns that they receive are in accordance with that level of risk.

1.2 An assurance engagement normally exhibits the following elements:

(1) A three-party relationship:

(a) A practitioner, in this case the auditor

(b) A responsible party, in this case Knoll plc

(c) An intended user, in this case the directors and shareholders of Knoll plc

(2) Subject matter, in this case the risk management procedures

(3) Suitable criteria, which in this case will depend on the specific needs of the company

(4) Evidence gathered

(5) An assurance report

1.3 The matters to be considered would be as follows:

(1) Whether there is any conflict of interest as a result of performing the statutory audit as well as this assignment and whether the firm would be able to perform the engagement in accordance with the FRC Revised Ethical Standard

(2) The level of assurance required by the client and the form of the report to be issued

(3) The specific recipients of any report and the use which will be made of the report

(4) The terms of the engagement and in particular the criteria by which the risk management procedures are to be measured. These could include UK Corporate Governance Code and/or the management's policy on risk management. As there are no universally recognised criteria for evaluating the effectiveness of an entity's risk evaluation, assurance is likely to be limited to whether evaluation is properly carried out

(5) The risk to the audit firm of performing the assurance engagement and whether this can be reflected adequately in the fee chargeable

Answer to Interactive question 2

2.1 As the report is to be sent directly to the bank, the engagement is with the bank and not Kelly plc. Therefore the engagement letter should be addressed to the bank.

2.2 The matters to be addressed in the letter of engagement include the following:

- The nature of the work which is being conducted ie, in accordance with the terms of the lending agreement
- The respective responsibilities. The directors are responsible for ensuring that the company complies with the terms of the loan agreement, both in terms of the covenants and the preparation of the statement of compliance. The auditors are responsible for reporting to the bank on the statement of compliance

- The basis of the report. This would include:
  - the standards to which the work is performed, such as ISQM (UK) 1 and ISAE (UK) 3000;
  - the extent of the procedures to be performed;
  - any limitations in the work to be performed ie, what the work will not cover; and
  - restrictions on the use of the report ie, for use by the bank in respect of the loan agreement and not for use by other third parties.

2.3 Procedures would include:

- reading the statement of compliance and obtaining an understanding of the way in which it was compiled through inquiry of management;
- comparison of the financial information in the statement and the source information from which it has been taken; and
- re-computation of the calculations and comparison of the results with those of the client and the requirements of the loan agreement.

Tutorial Note

Depending on the precise nature of the engagement and the terms set out in the engagement letter the auditor may also be required to review or verify the financial information which has provided the source for the calculations in the statement.

Answer to Interactive question 3

Implications:

(1) The ongoing costs and liabilities of the target company may be understated if the terms of the sales managers' contracts have not been correctly reflected in the information provided to the accountants. For example, the sales managers may have been promised bonuses which have not been accrued for. Without a proper review of the terms of their employment the accountants are not able to establish whether this is the case or not. If the documentation cannot be provided the shareholders may be required to provide a warranty on this issue.

(2) The ability of the target company to generate profits in future will have an impact on the valuation of the business. As the accountants have not been able to review a major sales contract they will not be able to confirm:

(a) the number of years remaining on the contract before it may go out to tender;

(b) whether the contract is transferable; or

(a) whether there are any liabilities associated with the contract which have not been disclosed. Again, warranties may need to be sought on this issue.

(3) Warranties may be provided by the sellers of a business as a 'guarantee' that they have disclosed all the relevant information about the target company. As the finance director does not own any shares and apparently therefore will not benefit from the sale of Lee Ltd, it is understandable that he does not wish to warrant the transaction. However, as he is in the position of finance director, this fact may undermine the confidence of Hill Ltd in the sale process and affect the share price. A potential solution would be to incentivise the finance director by offering him a bonus on completion of the sale in exchange for the warranties.

Answer to Interactive question 4

(a) All three of the forecasts to be reviewed should be prepared on a monthly basis and the following work would be required in order to consider their reasonableness.

Capital expenditure forecast

(1) Read estate agent's details and solicitors' correspondence and compare to the capital expenditure forecast to ensure that all expenditure (including sale price, surveyors' fees, legal costs, taxes on purchase) is included.

(2) Confirm the estimated cost of new furnishings by agreeing them to supplier price lists or quotations.

(3) Verify any discounts assumed in the forecast are correct by asking the suppliers if they will apply to this transaction.

(4) Confirm projected building and decoration costs to the relevant suppliers' quotation.

(5) Confirm the projected cost of specialist equipment (and relevant bulk discounts) to suppliers' price lists or websites.

(6) In the light of experience of other such ventures, consider whether the forecast includes all relevant costs.

(b) **Profit forecast**

As a first step it will be necessary to recognise that the residential home will not be able to generate any income until the bulk of the capital expenditure has been incurred in order to make the home 'habitable'. However, while no income can be anticipated, the business will have started to incur expenditure in the form of loan interest, rates and insurance.

The only income from the new building will be rent receivable from residents. The rentals which Mr Lawrence is proposing to charge should be assessed for reasonableness in the light of rental charged to similar homes in the same area. In projecting income it would be necessary to anticipate that it is likely to take some time before the home could anticipate full occupancy and also it would perhaps be prudent to allow for some periods where vacancies arise because of the 'loss' of some of the established residents.

The expenditure of the business is likely to include the following.

(1) **Wages and salaries**. Although Mr and Mrs Lawrence intend to work full time in the business, they will undoubtedly need to employ additional staff to care for residents, cook, clean and tend to the gardens. The numbers of staff and the rates of pay should be compared to similar local businesses of which the firm has knowledge.

(2) **Rates and water rates**. The estimate of the likely cost of these confirmed by asking the local council and/or the estate agents dealing with the sale of property.

(3) **Food**. The estimate of the expenditure for food should be based on the projected levels of staff and residents, with some provision for wastage.

(4) **Heat and light**. The estimates for heat, light and cooking facilities should be compared to similar clients' actual bills.

(5) **Insurance**. This cost should be verified to quotes from the insurance broker.

(6) **Advertising**. The costs of newspaper and brochure advertising costs should be checked against quotes obtained by Mr Lawrence.

(7) **Repairs and renewals**. Adequate provision should be made for replacement of linen, crockery and such like and maintenance of the property.

(8) **Depreciation**. The depreciation charge should be recalculated with reference to the capital costs involved being charged to the capital expenditure forecast.

(9) **Loan interest and bank charges**. These should be checked against the bank's current rates and the amount of the principal agreed to the cash forecast.

(c) **Cash flow forecast**

(1) Check that the timing of the capital expenditure agrees to the cash flow forecast by comparing the two.

(2) Compare the cash flow forecast to the details within the profit forecast to ensure they tie up, for example:

- Income from residents would normally be receivable weekly/monthly in advance.
- The majority of expenditure for wages etc, would be payable in the month in which it is incurred.
- Payments to the major utilities (gas, electricity, telephone) will normally be payable quarterly, as will the bank charges.
- Rates and taxes are normally paid half-yearly.
- Insurance premiums will normally be paid annually in advance.

(3) Re-perform the additions on the cash forecast and check that figures that appear on other forecasts are carried over correctly.

Answer to Interactive question 5

Procedures would involve the following:

To establish whether a fraud has taken place

- Obtain an understanding of the business and in particular the roles and responsibilities of those involved in processing inventory transactions and those in the warehouse.
- Discuss with management the method adopted for conducting the quarterly inventory count and review the detail of the count instructions. Any weaknesses in the controls should be identified and considered as a possible explanation for the discrepancies eg, double counting of this particular line of inventory.
- Obtain confirmation of whether inventory is held at more than one location. If so confirm that this has been included in the physical inventory counts.
- Review procedures for the identification of obsolete and damaged items and in particular the disposal of such items. Determine who is responsible for making the decision and the procedures for updating records for these adjustments. If items have been disposed of but records not maintained this could explain the discrepancy.
- Obtain an understanding of the system for the processing and recording of despatches and in particular consider the effectiveness of controls regarding completeness of despatches. Trace transactions from order to despatch in respect of the inventory line in question to confirm that all goods out have been recorded.
- Obtain an understanding of the system for the processing and recording of goods received for this inventory line. Controls over the initial booking in of inventory should be reviewed. If inventory is double counted at this stage this could account for the discrepancy.
- Review the system for subsequent processing of goods received, in particular the controls and procedures regarding the accuracy of input. If goods in are processed more than once this would give rise to a discrepancy between the book records and actual inventory.

- Assess the existence of general controls affecting access to the warehouse and inventory.

To quantify the loss

The evidence obtained above should enable the auditor to determine the accuracy of the book records and the accuracy of the physical inventory records. A reconciliation of the two figures should provide the number of units missing. The cost of each unit should be agreed to recent purchase invoices.

Tutorial Note

In this particular case, the approach taken is likely to involve elimination of legitimate reasons why the discrepancies may have arisen.

Answers to Self-test questions

1 Travis plc

1.1 Key business risks (only four required) Risk with diversification

Scandinavia would be a new geographical area to the directors of Travis.

The culture and expectations of a Scandinavian workforce and Scandinavian business/holiday travellers may be very different to that in other areas where Travis operates.

Regulatory environment

The directors of Travis will need to ensure that the company quickly gains knowledge of regulations in the Scandinavian countries to ensure that local laws are not breached by future decisions eg, local health and safety rules, local employment legislation.

Change measurement

The takeover of Bandic will be potentially unsettling for the Bandic workforce.

- Head office staff may think their jobs are at risk, as control may be subsumed within the head office function of Travis.
- Hotel staff may be concerned about the future of the hotel in which they work.

This uncertainty is demotivating and can have serious performance consequences if decisions are not made quickly and communicated effectively.

Financing

Travis must ensure that it does not overstretch itself when making an acquisition. A balance must be struck between using existing resources and raising new finance via debt and/or equity that the new entity is comfortably able to service.

Systems

Computer systems in Bandic will need to be integrated so that:

- reporting to the Travis board can be carried out, especially when integrating results for overall control; and
- if the group wants standard booking/check-in procedures etc, Bandic's systems will need more thorough integration.

1.2 Due diligence

When bidding for the shares in its chosen company, Travis and its advisers will have only limited access to financial information on that company.

A due diligence exercise is carried out by Travis once it has identified the target company. This would usually be performed by the purchasing company together with its external advisers, and would give a much more detailed review of the assets, liabilities, contracts in progress, risks, etc, of the acquired company, to confirm that the original information relied on by Travis was accurate.

An acquisition deal will not become unconditional until after satisfactory completion of a due diligence exercise.

2 Upstarts Ltd

Email as follows:

To: The engagement partner

From: Senior in corporate services

Date: Today

Subject: Potential assignment at GPSWGFM

Associated risks

The most important issue here is that our client, GPSWGFM, seems to have a somewhat naïve approach to this assignment. The buy-out is in a generally high risk area (see below), but the information we have indicates that the client is placing reliance upon the management team of Upstarts, without reference to the vendor.

This is exacerbated by the fact that the directors of Upstarts claim that its previous audited, filed accounts significantly understate its profits, and further still by the limits upon our due diligence work and by the vendor's refusal to provide any warranties.

A list of the risk factors associated with the transaction is set out below.

- The previous filed accounts are being restated, beneficially, by Upstarts, apparently without any means to verify this with the vendor
- Previous problems within Upstarts, in particular the breakdown in relations with DatLinks and its cash flow problems
- The overwhelming reliance upon management, who have a vested interest in overstating results – particularly in view of the share options which are being proposed
- The lack of warranties from the vendor
- The fact that the company is in a high technology sector which carries a high level of (inherent) risk
- Industry-wide problems (eg, the publicised security breach)
- The dependence upon key individuals remaining with the business – how likely is this?
- The potential adjustments to the accounts might well increase the company's statement of financial position, such that the EMI scheme no longer applies
- The planned Initial Public Offering will exacerbate the incentive to overstate results, as will the proposed share option scheme

Performance management

- The main supplier of hardware to Upstarts is the parent company DatLinks. Therefore new suppliers may need to be sourced, thereby increasing the risk of stock-outs and interruptions in supply and quality of supply.

Additionally, the following factors will affect our firm's own risk profile.

- The reliance by GPSWGFM on our due diligence work
- The potential conflict of interest – it might be perceived that the availability of ongoing work might prejudice our approach to the due diligence exercise (ie, it may be perceived that we have a vested interest in seeing the deal go through).
- The Initial Public Offering will increase our exposure still further, since the public will rely upon our work.

Many of the above-mentioned risks are pervasive across the whole range of advisory services we are considering offering. A summary of the key risks associated with each work stream is as follows.

- **Due diligence** – Reliance upon management; lack of management information; lack of warranties; previous financial difficulties; reliance upon our work by GPSWGFM; incentives to optimism by managers.
- **Business plan review** – The business plan and financial projections are an extension of the due diligence work ie, projecting forwards to calculate profitability. The risks will be as above, but with added risk because the integrity of projections in a relatively volatile market will need to be tested.
- **Tax structuring** – This relies upon the numbers in the financial projections. As Upstarts has suffered from cash flow problems recently, it will be important to determine the amount of any unpaid tax liabilities, as these could impact the company's valuation. If any losses have been incurred, how these unused losses can be preserved for offset against future profits needs to be considered. This is especially important in the light of the group's transfer pricing policies – there may be a risk of HMRC requiring transfer pricing adjustments, therefore increasing previous years' tax liabilities. How to structure the share option scheme, and the amount of any degrouping charges arising in Upstarts, also must be considered.
- **Audit** – Audit risk should be regarded as high: this is a new client to the firm, in an inherently risky market sector, with a history of financial problems. The reliance upon key staff will also affect audit risk, since the ability of Upstarts to continue as a going concern is dependent upon the retention of key personnel. Depending on the nature of the future listing ethical restrictions may apply in respect of the provision of both audit and other services.
- **Flotation** – This will extend the audit risk, since levels of reliance upon our work will be increased throughout the general public. The proposed share options will potentially motivate management to overstate results.

Overall, the deal should at this stage be regarded as very high risk – both for our client and for ourselves. There may be significant ethical issues in future.

For ourselves, we should seriously consider not quoting for any of these services, or quoting for only some parts of the work to avoid the potential conflict of interest noted above.

Chapter 26

Environmental and social considerations

Introduction

Learning outcomes

- Explain and evaluate corporate reporting and assurance issues in respect of social responsibility, sustainability and environmental matters for a range of stakeholders

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	**Introduction** Organisations now focus on explaining their role in more than just financial terms and this section explains why.	**Approach** Note the impact of this type of responsibility on corporate reputation. **Stop and think** Can you think of any other examples of policies that consider social and environmental factors?	Questions on this topic will require you to have a working knowledge of what companies say and how they say it, so be prepared to offer advice if required on how to set up similar types of disclosure.	N/A
2	**Social responsibility reporting** Without any formal template, companies can be as innovative as they like.	**Approach** Make sure you read all the various illustrations and can compare and contrast them. **Stop and think** Remember that many of these are revision for you!	You may be required to consider how a model such as the Global Reporting Initiative (GRI) or the UN Sustainability Goals might be applied to an organisation in a scenario.	**IQ1: Social/ environmental reporting** In order to score well here, answers to this question need to be very practical and draw on the facts presented.
3	**Implications for the statutory audit** How might social and environmental issues create audit risk within a set of financial statements?	**Approach** Work through this section and consider how social and environmental issues could have	Should a question ask for the implications of either a social or environmental matter on the audit, remember to	**IQ2: Provisions** This is a great way of applying your corporate reporting knowledge in the context of accounting for an environmental

Topic	Practical significance	Study approach	Exam approach	Interactive questions
		an impact on each stage of the audit. **Stop and think** The long term nature of such issues may make the financial statements more subject to risk of misstatement.	use the same approach for planning and collecting evidence as you would for purely financial issues.	issue.
4	**Social and environmental audits** Companies may be required to demonstrate that they have met certain social and/or environmental targets.	**Approach** In each instance, consider the work that a firm would do if asked to carry out such an audit. **Stop and think** How would you collect the necessary evidence here?	You need to be prepared to advise either a client or colleague on what these audits are for and how they work.	N/A
5	**Implications for assurance services** There are always opportunities for firms to offer additional services to their clients - social and environmental matters are no exception.	**Approach** Read the various approaches discussed and consider how they could be applied. **Stop and think** Does your employer offer services of this kind?	You may be presented with an offer to review something similar to the report shown in the worked example – if so, treat it like any other form of assurance and consider a step-by-step approach to how an engagement should be conducted.	**IQ3: Assurance services** Despite being set in a market you are probably unfamiliar with, this question should be approached like any other engagement.
6	**Integrated reporting** Stakeholders are becoming increasingly aware of how value is created from finite resources – integrated reports aim to communicate this by reference to the value of the	**Approach** There is a lot to get through in this section but the worked example demonstrates how various resources can create value. **Stop and think**	As usual, the biggest challenge in questions of this type is how you would perform an engagement to review such information – remember to stay focused on the	**IQ4: Auditing performance information** Don't forget to consider both absolute and relative measures and also to take any qualitative factors into account as part of your

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	various resources or capitals used and the corresponding value they create.	Can you differentiate between the various capitals?	practical aspects of the data and how it can be assessed.	analysis. **IQ5: Procedures** Your answers need to be very precise here.

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Introduction

Section overview

Many corporations are now compiling and issuing annual reports that provide details about their environmental and social behaviour.

1.1 Corporate responsibility

Traditionally management (and auditors) have been primarily concerned with one set of stakeholders, the shareholders on whose behalf they operate the business and to whom they report.

However, in recent years pressure on organisations to widen the scope of their **corporate public accountability** has come from the increasing expectations of other stakeholders, in particular concerning the environment, society and employees.

The environment	The environment is directly impacted by many corporate activities today. For example a company can cause harm to natural resources in various ways, including: exhausting natural resources such as coal and gas; and emitting harmful toxins which damage the atmosphere. This impact is regulated by environmental legislation and consumer opinion.
Society	Society, from the point of view of the company, is made up of consumers or potential consumers. As recognised above, consumers increasingly have opinions about 'green', environmentally friendly products and will direct their purchasing accordingly. They are concerned with harm to natural resources as they and their children have to live on the planet and may suffer direct or indirect effects of pollution or waste. Society will also, through lobby groups, often speak out on behalf of the environment as it cannot speak out itself.
Employees	Employees have a relationship with the company in their own right, in terms of their livelihood and also their personal safety when they are at work. However, from the company's perspective, they are also a small portion of society at large, as they may purchase the products of the company or influence others to do so.

Corporate responsibility is a field which is still developing. As a result, what constitutes corporate responsibility is part of an ongoing debate. ICAEW (in *An Overview of Corporate Responsibility*) defines it as the 'actions, activities and obligations of business in achieving sustainability'. If a business is to be sustainable in the long run then the resources it uses must be sustainable. This includes raw materials and energy and so on but also includes less tangible resources including:

- human and intellectual capital; and
- relationships with communities, governments, consumers and other stakeholders.

The business argument is that companies that are responsible will in the long term be more successful. This gives rise to both:

- risk eg, reputational risk as a result of poor behaviour; and
- opportunity eg, companies that use energy efficiently will reduce cost.

You will remember that we have covered topics such as environmental, social and governance (ESG) factors and sustainability earlier in these materials. In this chapter, we are trying to draw it all together.

1.2 Reputation

For a company, however, there is one simple need. Companies desire above all else to keep making their products and to keep making sales. Increasingly to achieve this a business must have the reputation of being a **responsible business that enhances long-term shareholder value** by addressing the needs of its stakeholders. Where this is not seen to be the case, evidence indicates that **consumers will take action**. For example, consumer campaigns have targeted Nike for alleged exploitation of overseas garment-trade workers and McDonald's for alleged contribution to obesity and related illness.

Therefore it is important for companies to have **policies in order to appease stakeholders** and to **communicate** the policies to them.

As a result, many companies have developed specific policies to address social and environmental concerns.

Examples

The following illustrate the wide-ranging nature of these policies:

- Johnson & Johnson generates 30% of its total US energy from green power sources such as wind power, on-site solar, low impact hydro, renewable energy sources.
- IBM have installed energy saving devices including installing motion detectors for lighting in bathrooms and copier rooms and rebalancing heating and lighting systems.
- Polaroid requires each employee to identify energy-saving projects as part of their performance evaluation.
- Banks have introduced a 'green' credit card which donates a proportion of profits to environmental causes and charges a lower interest rate on 'green purchases'.

This puts governance into a wider context.

Context example: BP oil spill 2010

On 20 April 2010 a BP drilling rig exploded in the Gulf of Mexico resulting in the death of a number of employees and the largest offshore oil spill in US history. This proved to be not only a catastrophic environmental disaster but also severely damaged the reputation of the company. Before the accident BP was the UK's biggest company, with a stock market value of £122 billion. By early June 2010 £49 billion had been wiped off the company's value and relations with the US Government were strained. Dividend payments were suspended until the fourth quarter of 2010 and the financial statements for 2010 showed a pre-tax charge of $40.9 billion relating to the accident and spill.

The effects of this event continue to feature prominently in BP's annual report: in 2017, payments related to this exceeded $5 billion, more than the company's reported profits due to shareholders, with similar sums expected in subsequent years.

2 Social responsibility reporting

Section overview

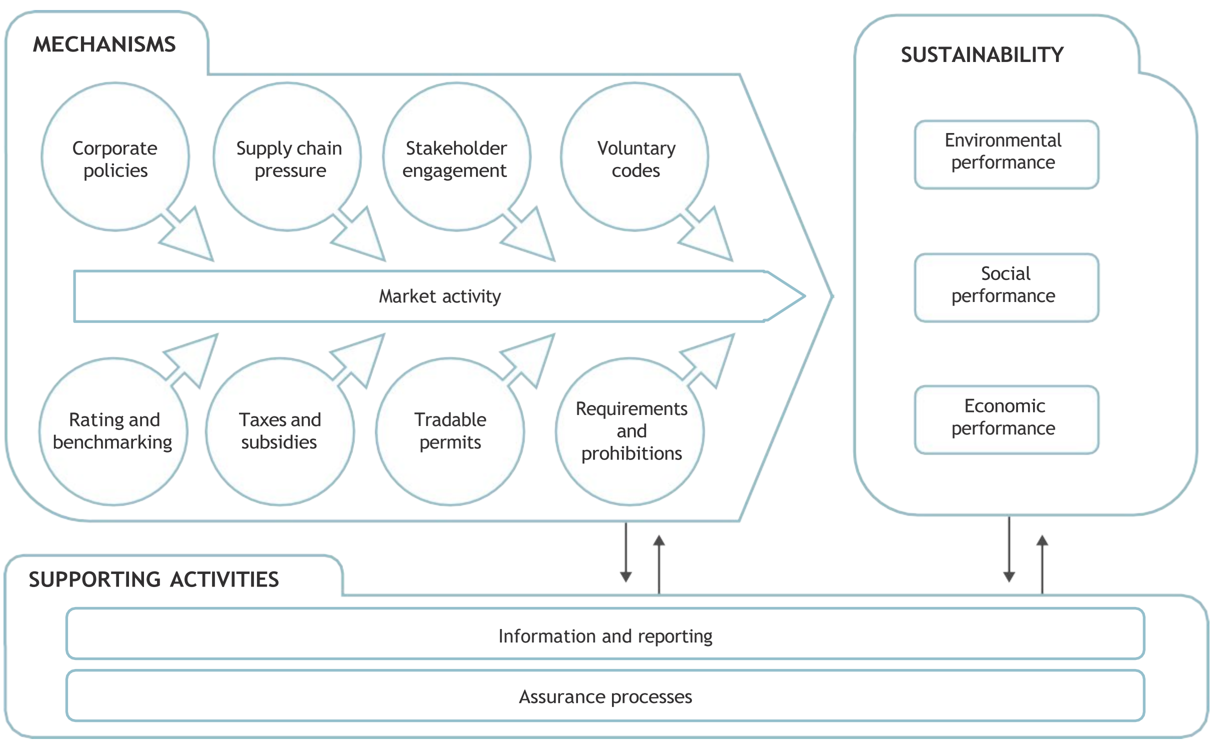
- Many companies are adopting 'triple bottom line' reporting.
- Sustainability and climate-related factors can be reported in a variety of ways.
- Companies may also produce employee and employment reports.

2.1 Sustainability reporting

Sustainability is defined as maintaining the world's resources rather than depleting or destroying them. This will ensure they support human activity now and in the future. Sustainable business is the actions, activities and obligations of business in achieving sustainability. It involves reconnecting business, society and the environment and recognising their interdependence. There are a number of mechanisms which can be used by individuals, societies and governments to enhance sustainability supported by reliable information on which assurance has been provided by the accountant.

The sustainability reporting can be summarized as follows:

Figure 26.1: A market-based approach to sustainability



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As shown in the diagram above, sustainability can be seen to have three key aspects:

Economic	Information provided goes beyond that required by law. It should demonstrate how a company generates value in a wider sense eg, by creating human capital
Environment	This may provide information about the impact of products on the environment eg, emissions, waste
Social	Information may be provided on a range of social issues, including ethnic and gender diversity, child labour, working hours and wages

As well as adopting social and environmental policies it is important that companies **communicate these policies** to stakeholders. Increasingly companies are providing information on **sustainability**. This type of report typically includes information about these three aspects of performance and is often referred to as **triple bottom line reporting**.

2.2 Regulation

There is currently **no consensus** on the type of information that should be disclosed in a sustainability report. Historically companies whose activities have the greatest social and environmental impact have been the most active in developing this type of reporting, for example companies within the oil and gas industry like Shell. In more recent years **sustainability reporting has become more common** but guidance is still at an early stage of development.

An increasing number of companies including BT, Vauxhall Motors and British Airways are following guidance issued by the **Global Reporting Initiative** (GRI). The GRI aims to develop **transparency, accountability, reporting and sustainable development**. Its vision is that reporting on economic, environmental and social impact should become as routine and comparable as financial reporting.

In October 2016 GRI launched the GRI Sustainability Reporting Standards. These replace the previous G4 Guidelines, although the new Standards are based on these. The Standards are made up of a set of 36 modular standards.

This includes three universal standards which are to be used by every organisation that prepares a sustainability report:

- GRI 101, *Foundation*

This sets out the Reporting Principles.

- GRI 102, *General Disclosures*

This is used to report contextual information about an organisation and its sustainability reporting practices. This includes information about an organisation's profile, strategy, ethics and integrity, governance, stakeholder engagement practices and reporting processes.

- GRI 103, *Management Approach*

This is used to report information about how an organisation manages a material topic.

The Reporting Principles as set out in GRI 101 are as follows:

Reporting principles for defining report content

- **Stakeholder inclusiveness**: The organisation should identify its stakeholders and explain how it has responded to their reasonable expectations and interests.
- **Sustainability context**: The report should present the organisation's performance in the wider context of sustainability.

- **Materiality**: The report should cover aspects that reflect the organisation's significant economic, environmental and social impacts or substantively influence the assessments and decisions of stakeholders.
- **Completeness**: The report should include coverage of material aspects and their boundaries sufficient to reflect economic, environmental and social impacts, and to enable stakeholders to assess the organisation's performance in the reporting period.

Reporting principles for defining report quality

- **Balance**: The report should reflect positive and negative aspects of the organisation's performance to enable a reasoned assessment of overall performance.
- **Comparability**: The organisation should select, compile and report information consistently. The reported information should be presented in a manner that enables stakeholders to analyse changes in the organisation's performance over time and that could support analysis relative to other organisations.
- **Accuracy**: The reported information should be sufficiently accurate and detailed for stakeholders to assess the organisation's performance.
- **Timeliness**: The organisation should report on a regular schedule so that information is available in time for stakeholders to make informed decisions.
- **Clarity**: The organisation should make information available in a manner that is understandable and accessible to stakeholders using the report.
- **Reliability**: The organisation should gather, record, compile, analyse and disclose information and processes used in the preparation of a report in a way that can be subject to examination and that establishes the quality and materiality of the information.

(Source: https://www.globalreporting.org/standards [Accessed 27 May 2022])

Prominent Note

Although the GRI remains in force, the imminent launch of the International Sustainability Standards Board (ISSB) IFRS S1 and IFRS S2 has become the prime method for sustainability and climate-related disclosures.

2.2.1 Accounting for Sustainability

Accounting For Sustainability (A4S) works to inspire action by finance leaders to drive a fundamental shift towards resilient business models and a sustainable economy. To do this A4S has three core aims:

(a) Inspire finance leaders to adopt sustainable and resilient business models.

(b) Transform financial decision making to enable an integrated approach, reflective of the opportunities and risks posed by environmental and social issues.

(c) Scale up actions across the global finance and accounting community.

A4S currently has a number of ongoing projects which are split into four main themes:

(a) Lead the way: Developing a strategic response to macro sustainability trends

(b) Transform your decisions: Integrating material sustainability factors into decision making

(c) Measure what matters: Developing measurement and valuation tools

(d) Access finance: Engaging with finance providers on the drivers of sustainable value

Context example: Sustainability report

The following is an extract from sportswear manufacturer Puma's sustainability report for 2017:

T.1 *PUMA 10FOR20 SUSTAINABILITY TARGETS PERFORMANCE SUMMARY*

TARGET	BASELINE 2015	PERFORMANCE 2017	PLANNED ACTION 2018	TARGET 2020	STATUS
01 Stakeholder Engagement	• Talks at Banz • Supplier round tables	• Talks in Hong Kong, supplier round tables including external stake-holders	• Alternate global stakeholder meetings between Europe and Asia. Continue round tables in all major sourcing markets	• Stakeholder dialogue, public reporting, consumer information	On track
02 Human Rights	• Human rights screening	• Human rights assessment expanded to supply chain • Employee volunteering platform operational, >17,000 hours of com-munity engagement • Partnership with Right To Play formalized	• Implement suggested measures from human rights assessment • Continue employee volunteering on global scale	• Embed human rights across our opera-tions and suppliers • Positively impact communities where PUMA is present	On track
03 Social Compliance	• All Tier 1 suppliers frequently audited • Workers' com-plaints received and processed	• Joint industry assess-ment tool (SLCP) piloted • 27% of audits shared • Number of zero toler-ance issues not dealt with at the end of the year: 0	• No zero tolerance is-sues not dealt with at the end of the year • Implement joint industry assessment tool (SLCP) • Increase percentage of shared audits to 50%	• Compliance with industry standards/ ILO Core Conven-tions for all core suppliers, including suppliers of finished goods as well as component and material suppliers	On track
04 Health & Safety	• OHS part of compliance audits	• Fatal accidents PUMA: 0 Suppliers: 1 • Injury rate PUMA: 0.72 Suppliers*: 0.61	• Zero fatal accidents • Average injury rate of PUMA entities below 1	• Zero fatal accidents • injury rates below industry average	Fatal accidents: not on track Injury rates: on track
05 Climate Change	• Science-based-target development announced	• Science-based target submitted for review • 3% interim reduction target • PUMA (Scope 1&2) relative to turnover: -5% (tbc) Scope 3: -7%	• Formation of an in-dustry working group on climate change; expand supply chain climate projects to cover top 3 countries	• Science-based reduction target to be developed and implemented	SBT: not on track 3% reduction on track

Table 1 gives an overview of our target performance. For a detailed summary of our progress towards our individual targets, please refer to the chapter for each target area.

*

TARGET	BASELINE 2015	PERFORMANCE 2017	PLANNED ACTION 2018	TARGET 2020	STATUS
06 Chemicals	Commitment to Zero Discharge of Hazardous Chemicals [ZDHC]	PFC phase out: 99% of products PFC-free RSL failure rate: 2.2% VOC Index for shoes: 20.9 g/pair	Keep RSL failure rate below 3% Pilot ZDHC Chemicals Gateway for MRSL check of supplier chemical inventories Reduce VOC consumption per pair of shoes below 20 g/pair	Zero Discharge of Hazardous Chemicals from our supply chain	On track
07 Water & Air	Start of wastewater testing and tests' results publication	ZDHC wastewater guideline implemented at core suppliers Air emissions study for Chinese suppliers completed		Industry best practice on water treatment and air pollution is met by 90% of PUMA core suppliers	Water: on track Air: need to speed up efforts
08 Materials	bluesign [polyester], Leather Working Group [leather] and FSC [paper & cardboard] certification used in significant volumes	Apparel Cotton: BCI 40% Polyester: bluesign: 47% Footwear Leather: LWG: 99% Cardboard & Paper: FSC: 95% Accessories Polyester: Bluesign: 34%	FSC: 90% LWG: 90% bluesign: 40% BCI: 40%	More sustainable materials used for our key materials FSC: 90% LWG: 90% bluesign: 50% BCI: 50% [PU target in development]	On track
09 EP&L	Kering Group EP&L published [including PUMA figures]	PUMA EP&L 2016 published	Reduce EP&L value per unit of turnover	Continue to report yearly on our impact PUMA EP&L value significantly reduced	On track
10 Governance	PUMA Code of Ethics training with low participation rate Ethics training participation rate: 60%	PUMA Code of Ethics training participation rate: 99% [of all staff with email accounts] 353 suppliers trained in anti-corruption measures Anti-corruption section included in supplier audit tool	Ensure rate of training for PUMA staff [with email accounts] remains over 95% Expand supplier training sessions to cover 80% of all suppliers	Maintain and run a state-of-the-art compliance system	On track

(Source: Puma (2017) *Annual Report 2017*. [Online]. Available from: https://annual-report-2017.puma.com/en/company-overview/sustainability/ [Accessed 27 May 2022])

2.3 Advantages and disadvantages of sustainability reporting

The **advantages** are as follows:

- Employee satisfaction leads to improved customer service.
- Improved stakeholder satisfaction leads to increased financial performance.

- Investors want to see a company adopt practices that are more environmentally sustainable.
- Abuses of environment/human rights can damage reputations and hence share prices.
- Using resources efficiently can save money.

The **disadvantages** are as follows:

- Focus should be strictly on satisfying shareholders' desire for financial return.
- Shareholders' value may be reduced if profits are lost.
- Initially costs are incurred to become 'green'.
- Allegations of 'greenwashing' may lead to a damaged reputation.

Interactive question 1: Social/environmental reporting

Westwitch plc is a multinational energy group, recently quoted on the London Stock Exchange. Among its many activities the group operates an oil refinery in Nigeria, a nuclear waste disposal facility in South Africa, and coal extraction in South America.

Requirement

How might the publication of a social/environmental report benefit Westwitch plc?

See **Answer** at the end of this chapter.

2.4 Employee and employment reports

Continuing the theme of increased information to stakeholders, the use of **employee and employment reports** has been much debated.

Companies employ large numbers of individuals and thus have certain responsibilities, both to the employees themselves and to society at large, to behave appropriately to them.

An employee report is an annual report for use by the employees to help simplify the information. It uses **non-technical language** with charts, diagrams, etc. It aims to give these particular stakeholders the opportunity to understand fully the assurances they require over the business.

It is recommended that an employment report be added to the annual report to include details of a company's employees, eg, numbers employed, age, geographical location, hours worked, pension schemes, staff training, and health and safety. This would furnish stakeholders with more information than that required by law.

2.5 UN Sustainable Development Goals

The UN Global Goals for Sustainable Development aim to transform our world by 2030.

The Global Goals aim to end poverty, combat climate change and fight injustice and inequality. Their vision is a world of strong economies and the Global Goals illuminate this: it is one of prosperous, inclusive and resilient economies, based on fair and just societies, delivered within what nature can afford and underpinned by good governance and strong partnerships. (Source: UN (n.d.) *Sustainable Development Goals*. [Online]. Available from: https://www.un.org/sustainabledevelopment/ [Accessed 27 May 2022])

The diagram below shows the 17 Global Goals, illustrating what the UN perceives to be the most important issues here.

The professional accounting bodies have a vital role to play in this:

- The actions businesses take will be critical to translating this vision into a new reality.
- As countries measure progress on the goals, the accountancy profession will have a major role in aligning measurement systems.
- The profession has a proven record of building strong local institutions – essential for achieving the goals.

Professional skills focus: Assimilating and using information

Having a framework such as that used by the GRI is very helpful in delivering a thorough and comprehensive view of an organisation's sustainability credentials. Note how this could be applied to almost any organisation in its own context.

3 Implications for the statutory audit

Section overview

- The auditor will need to consider the implications of social and environmental matters on the audit of the financial statements particularly at the following stages of the audit:
- Planning
- Substantive procedures
- Audit review

3.1 Introduction

As we have seen above, social and environmental matters are becoming significant to an increasing number of entities and may, in certain circumstances, have a **material impact on their financial statements**.

When these matters are significant to an entity, there may be a risk of material misstatement (including inadequate disclosure) in the financial statements. In these circumstances the auditor needs to give consideration to these issues in the audit of the financial statements. In Bangladesh, policy and regulatory initiatives are still limited. Bangladesh Bank issued green banking guidelines in 2011. As part of this guidelines all banks are required to prepare a standalone sustainability report effective from 2015. Dhaka Stock Exchange issued a sustainability reporting guideline in 2020 in collaboration with Global Reporting Initiatives (GRI). The aim is to encourage Bangladeshi companies to engage in sustainability reporting practices.

(Source: Current State of Corporate Sustainability Reporting Practices in Bangladesh-A Pilot Study By Professor Ataur Belal Phd FCA and Others available from https://www.icab.org.bd/icabadmin/uploads/ckeditor/9359Corporate%20Sustainability%20Reporting%20Practices%20by%20Prof%20Ataur%20Belal%20PhD%20FCA.pdf)

3.2 The consideration of environmental matters in the audit of financial statements

Examples of environmental matters affecting the financial statements could include the following:

- The introduction of environmental laws and regulations may involve an **impairment of assets** and consequently a need to write down their carrying value.
- Failure to comply with legal requirements concerning environmental matters, such as emissions and waste disposal, or changes to legislation with retrospective effect, may require **accrual of remediation, compensation or legal costs**.
- Some entities, for example in the extraction industries (oil and gas exploration or mining), chemical manufacturers or waste management companies may incur **environmental obligation** as a direct by-product of their core businesses.
- **Constructive obligations** that stem from a voluntary initiative, for example an entity may have identified contamination of land and, although under no legal obligation, it may have decided to remedy the contamination, because of its concern for its long-term reputation and its relationship with the community.
- An entity may need to disclose in the notes the existence of a **contingent liability** where the expense relating to environmental matters cannot be reasonably estimated.
- In extreme situations, non-compliance with certain environmental laws and regulations may affect the continuance of an entity as a **going concern** and consequently may affect the disclosures and the basis of preparation of the financial statements.

Context example

In November 2020, the FRC of UK published findings of a review which asked a series of questions to understand what's currently being done by major stakeholders in governance, reporting and audit to address climate-related issues. Here are the five questions asked:

(a) How are boards taking account of climate-related challenges?

(b) How are companies developing their reporting on climate-related challenges?

(c) How are auditors taking account of climate-related challenges?

(d) How are professional bodies and audit regulators taking account of climate change in their regulatory responsibilities?

(e) What do investors want to see?

Sadly, the answers to the first four questions are uninspiring. Climate-related issues still do not appear to be considered an integral part of an organisation's strategy and although there has been some progress in narrative reporting of climate issues in financial statements, such information is still very much seen as an optional extra (and probably will be until there is a legal requirement to disclose). The responses to climate-related challenges from auditors, professional bodies and regulators also appear to be mixed and undertaken in an ad hoc manner, all of which adversely affects progress in this area.

Taking all these points into consideration, the answer to the fifth question does not seem all that surprising. Investors clearly want more done in relation to disclosure around the impact of climate- related issues on organisations, especially the financial implications of such matters in order to be in a position to make informed financial decisions.

(Source: FRC, UK (2020) *Climate Thematic Headline Findings* [Online]. Available from: https://www.frc.org.uk/getattachment/4999d64b-1ee9-4e33-b306-e85572e6bdf8/Headline-Findings-FINAL.pdf [Accessed 27 May 2022])

3.2.1 The impact of climate-related and sustainability risks on the statutory audit

Beyond the more traditional view of environmental impacts on the audit, the launch of the International Sustainability Standards Board (ISSB) has **refined** how both **sustainability** and **climate- related risks** could affect organisations in a variety of ways.

In the context of the ISSB standards IFRS S1 and IFRS S2, such risks can vary as follows:

- Physical risks (either acute or chronic, as described below)
- Acute risks (immediate events such as forest fires)
- Chronic risks (longer-term systemic risks such as rising sea-levels)
- Transition risks (caused by the adaptation of an entity to a more sustainable form of economy)

Setting these in context, we can see that a chain of events has been triggered:

Factor	Impact
Extreme temperatures	These can have acute consequences (events such as forest fires or a more serious threat to life for vulnerable individuals) as well as more chronic effects (droughts contribute to increasingly lower water levels in reservoirs that service hydro-electric dams which can in turn lead to diminished power generation for communities).
Rising sea-levels	Global warming is melting polar ice-caps, leading to increased sea volumes and tidal swells which can affect coastal communities.
Shortage of resources	Adverse weather can also affect crop yields (such as wheat, potatoes and coffee) leading to supply chain issues that affect both quality and price.
Pricing issues	Shortages of key resources can increase prices which have an adverse effect on consumers and can have a strategic impact on the viability of certain industries, suppliers and retailers.
Changes in consumer tastes	Consumers changing their buying habits as a result of sustainability or climate-related factors may also have a strategic impact on certain industries or retailers (switching to a more sustainable product or service, such as replacing a car that uses petrol with an electric car, could become a more significant transition risk for a motor manufacturer). Inevitably, should an entity pursue a course of action that is at odds with the values of its stakeholders (such as failing to curb emissions or continuing with single-use plastics) this could ultimately lead to going concern problems.

Clearly, this is just scratching the surface of the problems faced by organisations as they attempt to navigate the 21st century. For auditors, these challenges are just as acute when tasked with identifying the risk of material misstatement in a set of financial statements. The IAASB audit practice alert The Consideration of Climate-Related Risks in an Audit of Financial Statement (IAASB, 2020) outlines some of the auditing standards that could be affected by climate-related risks and opportunities:

- ISAs 320 and 450 – **qualitative materiality factors** may be affected by the demands of users of financial statements with increased focus on climate-related risks and opportunities, leading to changes in what is now considered to be material
- ISA 250 (Revised) A on **laws and regulations** which are now enhanced since the launch of the ISSB
- ISA 540 (Revised) regarding **estimation uncertainty** over valuations and liabilities affected by climate-related risks and opportunities
- ISA 620 may require the appointment of even more **specialised forms of expert**
- Reporting using ISAs 700 (Revised), 701 and 720 (Revised) that reflects the **new disclosure landscape** as well as those items that may now be considered **key audit matters**

Source: IAASB (2020) *The Consideration of Climate-Related Risks in an Audit of Financial Statement* [Online]. Available at: https://www.ifac.org/system/files/publications/files/IAASB-Climate-Audit- Practice-Alert.pdf [Accessed 23 June 2022]

3.3 Planning the audit

Social and environmental issues impact on the planning of the audit in two ways:

- **Understanding the entity**
- **Inherent risk assessment**

As part of their knowledge of the business, the auditor should ensure they are competent by possessing an awareness of any environmental regulations the business is subject to, and any key social issues arising in the course of the business.

Questions which the auditor may need to ask include the following:

- Does the entity operate in an industry that is exposed to significant environmental risk that may adversely affect the financial statements of the entity?
- What are the environmental issues in the entity's industry in general?
- Which environmental laws and regulations are applicable to the entity?
- Have any regulatory actions been taken or reports been issued by enforcement agencies that may have a material impact on the entity and its financial statements?
- Is there a history of penalties and legal proceedings against the entity or its directors in connection with environmental matters? If so, what were the reasons for such actions?

The auditor may also be able to obtain knowledge of this aspect of the business by reading the entity's procedures manual or reviewing any quality control documentation they have relating to standards. The auditor may be able to review the results of any environmental audits undertaken by the company.

This information will then form part of the assessment of **inherent risk**.

3.4 Substantive procedures

Social and environmental issues, particularly environmental issues, may impact on the financial statements in a number of ways. Some examples are given below.

- **Provisions** (for example, for site restoration, fines/compensation payments)

- **Contingent liabilities** (for example, in relation to pending legal action)
- **Asset values** (issues may impact on impairment or purchased goodwill/products)
- **Capital/revenue expenditure** (costs of clean up or meeting legal standards)
- **Development costs** (new products)
- **Going concern issues** (considered below under audit reviews)

The auditor will have to bear in mind the effects of social or environmental issues on the financial statements when designing **audit procedures**. We will now look at some potential audit procedures that would be relevant in three of the key areas above.

3.4.1 Asset values

The key risk that arises with regard to valuation is that assets might be impaired. IAS 36, *Impairment of Assets*, which you have covered in your Financial Reporting studies, requires an impairment review to be undertaken with regard to non-current assets if certain indicators of impairment exist. IAS 36 gives a list of indicators that an impairment review is required. The indicator relevant in this instance is a **significant change in the technological market, legal or economic environment of the business in which the assets are employed**.

The following procedures to identify asset impairments may be used:

- Inquire about any **planned changes in capital assets**, for example, in response to changes in environmental legislation or changes in business strategy, assess their influences on the valuation of these assets or the company as a whole.
- Inquire about **policies and procedures** to assess the need to write-down the carrying amount of an asset in situations where an asset impairment has occurred due to environmental matters.
- Inquire about **data gathered** on which to base estimates and assumptions developed about the most likely outcome to determine the write-down due to the asset impairment.
- **Inspect documentation** supporting the amount of the possible asset impairment and discuss such documentation with management.
- For any asset impairments related to environmental matters that existed in previous periods, consider whether the assumptions underlying a write-down of related carrying values **continue to be appropriate**.

Other procedures might also include the following:

- **Review of the board minutes** for indications that the environmental regulatory environment has changed
- **Review of relevant trade magazines or newspapers** to assess whether any significant adverse changes have taken place

If an impairment review has been undertaken, and the valuation of the asset has been adjusted accordingly, the auditor should **audit the impairment review**.

3.4.2 Provisions and contingencies

Guidance on accounting for provisions and contingencies is provided in IAS 37, *Provisions, Contingent Liabilities and Contingent Assets* which you have studied in Financial Reporting.

The IAS provides some helpful examples of environmental issues that result in **provisions** being required. These include circumstances where the company has:

- **an environmental policy such that the parties would expect the company to clean up contamination; or**
- **broken current environmental legislation.**

The auditor needs to be aware of any circumstances that might give rise to a provision being required, and then apply the recognition criteria to it.

Social and environmental issues may also give rise to **contingencies**. In fact, a contingent liability is likely to arise as part of a provisions review, where items highlighted do not meet the recognition criteria for a provision.

The following procedures may be performed to assess the **completeness** of liabilities, provisions and contingencies arising from environmental matters:

- Inquire about policies and procedures implemented to help **identify** liabilities, provisions and contingencies.
- Inquire about events or conditions that may give rise to liabilities, provisions or contingencies, for example:
  - violation of environmental laws and regulations;
  - penalties arising from violations of environmental laws and regulations; and
  - claims and possible claims for environmental damage.
- If site clean-up costs, future removal or site restoration costs or penalties have been identified, inquire about **any related claims or possible claims**.
- Inquire about, read and evaluate correspondence from regulatory authorities.
- For property abandoned, purchased or closed during the period, inquire about requirements for site clean-up or intentions for future removal and site restoration.
- Perform **analytical procedures** and consider the relationships between financial information and quantitative information included in the entity's environmental records (for example the relationship between raw material consumed or energy used, and waste production or emissions, taking into account the entity's liabilities for proper waste disposal or maximum emission levels).

Interactive question 2: Provisions

Mole Mining Company Ltd carries out quarrying activities. It has recently obtained planning permission to mine at a new location. A condition of the planning consent is that environmental damage caused by the opening of the mine must be remedied on completion of quarrying. The company must also remedy any damage caused by the subsequent mineral extraction.

At the year end the mine has been opened but no mining has taken place.
Requirement

What are the factors which the auditor needs to consider in respect of any possible provision for environmental damage?

See **Answer** at the end of this chapter.

3.5 Audit reviews

Key issues include:

- going concern
- non-compliance with laws and regulations

Environmental and social issues can impact on the ability of the company to continue as a **going concern**. ISA 570 (Revised), *Going Concern* is covered in earlier Chapter.

The auditors' responsibility with regard to laws and regulations is set out in ISA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements*. You have studied this topic in Audit and Assurance at Professional Level.

In the context of environmental and social auditing, environmental obligations would be core in some businesses (for example, oil and chemical companies); in others they would not. ISA 250 (Revised) talks of laws that are **'central'** to the entity's ability to carry on business.

Clearly, in the case of a company which stands to lose its operating licence to carry on business in the event of non-compliance, environmental legislation is central to the business.

In the case of social legislation, this will be a matter of **judgement** for the auditor. It might involve matters of employment legislation, health and safety regulation, human rights law and such matters which may not seem core to the objects of the company, but which permeate the business due to the needs of employees.

Professional skills focus: Structuring problems and solutions

Systematically working through all the various elements of a set of financial statements will help you identify the implications of both social and environmental factors for the auditor.

4 Social and environmental audits

Section overview

- Social audits determine whether the company is acting in a socially responsible manner and in accordance with objectives set by management.
- Environmental audits assess the extent to which a company protects the environment from the effects of its activities in accordance with the objectives set by management.

4.1 Social audits

The process of checking whether a company has achieved set targets may fall within a social audit that a company carries out.

Social audits involve the following:

- Establishing whether the firm has a **rationale** for engaging in socially responsible activity
- Identifying that all **current environment programmes** are congruent with the mission of the company
- Assessing the **objectives and priorities** related to these programmes
- **Evaluating company involvement** in such programmes past, present and future

Whether or not a social audit is used depends on the degree to which social responsibility is part of the **corporate philosophy**. A cultural awareness must be achieved within an organisation in order to implement environmental policy, which requires board and staff support.

Many organisations now promote the **social impact** of their operations as well as their environmental effects, with companies as diverse as Apple, Starbucks, Nike and even Facebook working hard to promote the positive role they play on the human and social elements of their business models.

4.2 Environmental audits

Environmental audits seek to assess how well the organisation performs in **safeguarding the environment** in which it operates, and whether the company **complies with external regulations and its own environmental policies** (including legal requirements, recognised

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standards such as the ISO 14000 family of standards and satisfying key customers'/suppliers' criteria).

The auditor will carry out the following steps:

- **Establish the metrics used by reviewing the company's environmental policy**
- **Measure planned or desirable performance against actual performance** (This is an important aspect of a system. Some metrics will be objective, such as the level of carbon emissions or plastic bags issued, and can be measured. However, others like public perceptions cannot be measured objectively and may therefore be more difficult to measure precisely.)
- **Report results** (Key decisions will include the form of the report and how widely it should be distributed, in particular whether the annual report should include a report by the auditors.)

5 Implications for assurance services

Section overview

Environmental and social issues provide an opportunity for the auditor to provide other assurance services

5.1 Types of service

5.1.1 Assurance on sustainability reporting

Auditors can provide a variety of assurance services in respect of environmental and social issues. We have looked at assurance engagements in detail in earlier Chapters, therefore in this chapter we will consider engagements specifically related to sustainability issues.

If directors issue an environmental and social report, it may contain figures and statements that are verifiable.

The earlier sections of this chapter have highlighted the growing importance of environmental and sustainability reporting. The credibility of this information can be enhanced by an assurance process. In the same way that there is no one generally accepted set of rules for environmental and sustainability reporting, there is currently no specific standard that applies to the related assurance assignments. However, ISAE 3000 (Revised), *Assurance Engagements Other than Audits or Reviews of Historical Financial Information* is relevant and firms may also make use of the assurance standard AA1000AS (*Assurance Standard)*, issued by AccountAbility as a guidance and reference to promulgation of similar standard setting body.

AccountAbility is a global non-profit network that works with businesses and governments to promote accountability innovations that advance sustainable development. In 2018 it revised its reporting standard, AA1000 *Accountability Principles,* which establishes four principles for sustainability reporting.

Inclusivity	For an organisation that accepts its accountability to those on whom it has an impact and who have an impact on it, inclusivity is the participation of stakeholders in developing and achieving an accountable and strategic response to sustainability.
Materiality	Materiality is determining the relevance and significance of an issue to an organisation and its stakeholders. A material issue is an issue that will influence the decisions, actions and performance of an organisation or its stakeholders.
Responsiveness	Responsiveness is an organisation's response to stakeholder issues that affect its sustainability performance and is realised through decisions, actions and performance, as well as communication with stakeholders.
Impact	Impact is the effect of behaviour, performance and/or outcomes, on the part of individuals or an organisation, on the economy, the environment, society, stakeholders or the organisation itself. Material topics have potential direct and indirect impacts – which may be positive or negative, intended or unintended, expected or realised, and short, medium or long term.

Much of the guidance in the AA1000AS standard is very similar to ISAE 3000 (Revised), but there are areas where it gives more specific guidance:

- The **objective of the engagement** is to evaluate and provide conclusions on:
  - the nature and extent of adherence to the AA1000 principles; and, if within the scope agreed with the reporting company
  - the quality of publicly disclosed information on sustainability performance.
- Any **limitation in the scope** of the disclosures on sustainability, the assurance engagement or the evidence gathering shall be addressed in the assurance statement and reflected in the report to management if one is prepared.
- There is no set wording for the assurance statement but the following is listed as the minimum information required:
  - Intended users of the assurance statement
  - The responsibility of the reporting organisation and of the assurance provider
  - Assurance standard(s) used, including reference to AA1000AS (2008)
  - Description of the scope, including the type of assurance provided
  - Description of disclosures covered
  - Description of methodology
  - Any limitations
  - Reference to criteria used
  - Statement of level of assurance
  - Findings and conclusions concerning adherence to the AA1000 *Accountability Principles* of Inclusivity, Materiality, Responsiveness and Impact (in all instances)
  - Findings and conclusions concerning the reliability of specified performance information (for Type 2 assurance only)
  - Observations and/or recommendations
  - Notes on competencies and independence of the assurance provider
  - Name of the assurance provider
  - Date and place

Professional skills focus: Concluding, recommending and communicating

Although there are obvious differences in the type of engagement undertaken here and the way the statement is laid out, you should note the similarities to the auditor's report (such as the use of conclusions, methodology and responsibilities) which underlines the importance of being able to explain your findings whatever the circumstances.

Interactive question 3: Assurance services

Your audit client, Naturascope Ltd, is a health food and homeopathic remedies retailer, with a strong marketing emphasis on the 'natural' elements of the products and the fact that they do not contain artificial preservatives.

The directors have decided that it would benefit the company's public image to produce a social and environmental report as part of their annual report. There are three key assertions which they wish to make as part of this report:

(1) Goods/ingredients of products for sale in Naturascope have not been tested on animals.

(2) None of Naturascope's overseas suppliers use child labour (regardless of local laws).

(3) All Naturascope's packaging uses recycled materials.

The directors have asked the audit engagement partner whether the firm would be able to produce a verification report in relation to the social and environmental report.

Requirements

3.1 Identify and explain the matters the audit engagement partner should consider in relation to whether the firm can accept the engagement to report on the social and environmental report.

3.2 Comment on the matters to consider and the evidence to seek in relation to the three assertions.

See **Answer** at the end of this chapter.

5.2 Due diligence and sustainability

Due diligence engagements were covered earlier but this is another area where there is an increasing emphasis on environmental and other corporate responsibility issues.

6 Integrated reporting

Section overview

Integrated reporting is borne out of an increasing demand for companies to disclose a more holistic view of how a company creates value. The Integrated Reporting Framework seeks to determine value creation through the communication of qualitative and quantitative performance measures. However, in Bangladesh, the adoption of Integrated Reporting is not mandatory and in absence of an integrated set of standards, companies have been providing environmental, social and governance information in disconnected strands within their annual reports.

6.1 Rise of integrated reporting

In recent years there has been increasing demand for the senior management in large organisations to provide greater detail on how they use the resources at their disposal to create value. Traditional corporate reporting which focuses on financial performance is said to tell only part of the story.

Integrated reporting is concerned with conveying a wider message on an entity's performance. It is not solely centred on profit or the organisation's financial position but details how its activities interact to create value over the short, medium and long term.

The Institute of Chartered Accountants of Bangladesh (ICAB) is now moving in strides and has positioned itself formidably to develop awareness and promote the application of Integrated Reporting in the financial and corporate sectors of Bangladesh. It is now organizing Annual Best Published Reports and Corporate Governance Awards. All these are creating an environment where Integrated Reporting is becoming a way to make profit by taking care of people and planet. Types of capital

The integrated reporting framework by IFRS Foundation classifies the capitals as:

Capital	Comment
Financial capital	The pool of funds that is: • available to an organisation for use in the production of goods or the provision of services; and • obtained through financing, such as debt, equity or grants, or generated through operations or investments.
Manufactured capital	Manufactured physical objects (as distinct from natural physical objects) that are available to an organisation for use in the production of goods or the provision of services. Manufactured capital is often created by other organisations, but includes assets manufactured by the reporting organisation for sale or when they are retained for its own use
Intellectual capital	Organisational knowledge-based intangibles
Human capital	People's competencies, capabilities and experience, and their motivations to innovate
Natural capital	All environment resources and processes that support the prosperity of an organization
Social and relationship capital	The institutions and the relationships within and between communities, groups of stakeholders and other networks, and the ability to share information to enhance individual and collective wellbeing

(Source: *The International Integrated Reporting Framework*, www.theiirc.org [Accessed 27 May 2022])

Definition

Natural capital: This is defined in terms of forests, rivers, mountains, minerals, fish populations and even oceans.

The Natural Capital Committee of UK advised the UK Government on the sustainable use of its natural capital and also attempts to quantify the benefits derived by the nation from its natural assets, such as food, recreation, clean water, hazard protection and clean air. These benefits are reported by the Office for National Statistics in its annual UK natural capital accounts. Extracts from the 2021 release include the following:

- natural capital asset values were estimated as almost £1.2 trillion
- UK land-use emits more greenhouse gases than it removes
- renewable power generation is 21 times larger in 2020 than it was in 2003

The authors of the accounts conclude their findings by explaining their methodology and observing that their approach is based on a number of estimates and guidelines used by the United Nations. There is no assurance provided for this data, which perhaps says more about the challenges associated with generating this kind of information in a reliable and meaningful way than anything else.

(Source: Office for National Statistics (2021) UK Natural capital accounts: 2021. [Online] Available at: https://www.ons.gov.uk/economy/environmentalaccounts/bulletins/uknaturalcapitalaccounts/2021[Accessed 27 May 2022])

6.2 Interaction of capitals

Capitals continually interact with one another, and an increase in one may result in a decrease in another. For example, a decision to purchase a new IT system would improve an entity's 'manufactured' capital while decreasing its financial capital in the form of its cash reserves.

6.3 Short term vs long term

Integrated reporting forces management to balance the organisation's short-term objectives against its longer-term plans. Business decisions which are solely dedicated to the pursuit of increasing profit (financial capital) at the expense of building good relations with key stakeholders such as customers (social capital) are likely to hinder value creation in the longer term.

6.4 Monetary values

Integrated reporting is not aimed at attaching a monetary value to every aspect of the organisation's operations. It is fundamentally concerned with evaluating value creation through the communication of qualitative and quantitative performance measures. Key performance indicators are effective in communicating performance.

6.5 Materiality

When preparing an integrated report, management should disclose matters which are likely to impact on an organisation's ability to create value. Both internal and external threats regarded as being materially important are evaluated and quantified. This provides users with an indication of how management intend to combat risks should they materialise.

6.6 Implications of introducing integrated reporting

Implications	Comment
IT costs	The introduction of integrated reporting will most likely require significant upgrades to be made to the organisation's IT and information system infrastructure. Such developments will be needed to capture KPI data. Due to the broad range of business activities reported on using integrated reporting (customer, supplier relations, finance and human resources) it is highly likely the costs of improving the infrastructure will be significant.
Time/staff costs	The process of gathering and collating the data for inclusion in the report is likely to require a significant amount of staff time. This may serve to decrease staff morale if they are expected to undertake this work in addition to existing duties. This may require additional staff to be employed.
Consultancy costs	Organisations producing their first integrated report may seek external guidance from an organisation which provides specialist consultancy on integrated reporting. Consultancy fees are likely to be significant.
Disclosure	There is a danger that organisations may volunteer more information about their operational performance than intended. Disclosure of planned strategies and key performance measures are likely to be picked up by competitors.

6.7 Auditing integrated reports

One central problem faces auditors auditing integrated reports: how to measure the effect of one variable on another, when no independent variable can be isolated? This is the problem of the **complexity** of the social world. One might, for instance, decide to measure the performance of a school in terms of the examination performances of its students. The immediate difficulty is that a student's performance is not simply the result of one variable (the school) but results from a large number of different factors, such as the student's level of education on entering the school, the educational environment in the student's home life, the amount of time available to the student for study rather than paid work (the list goes on).

It is thus necessary to take great care when designing performance measures to take into account the effect of other factors on the reported metric. In practice the auditor will often **adjust** figures to take into account the effect of other variables.

Interactive question 4: Auditing performance information

Two hospitals, North Hospital and South Hospital, are required to report information in relation to the mortality of patients undergoing cardiothoracic (heart) surgery. The following information was reported.

Hospital	Number of patients	Number of planned procedures	Number of deaths
North	763	610	23
South	549	494	19

Of the deaths experienced in North Hospital, 12 were patients who died during planned procedures (the rest were emergency procedures). At South Hospital 7 patients died during planned procedures.

Requirement

Analyse the performance of the two hospitals and identify the better performing hospital. See

Answer at the end of this chapter.

6.7.1 Incentives and manipulation

An important difficulty in the use of performance information is that of **manipulation** of the reported figures (indeed, this is part of the reason for this information being subject to audit in the first place). This could take the form of straightforwardly doctoring the report figures, but perhaps more damaging is the risk that those being measured change their **behaviour** in order to improve the reported figures, without actually improving performance. This is the problem of **dysfunctional behaviour**.

A simple example of this is a measure of the speed in answering letters, which is not balanced by a measure of the quality of responses. This might encourage people to answer letters quickly, but badly.

Context example: Healthcare targets

A public sector healthcare provider was set a target for the maximum length of time a patient would have to wait in emergency departments before being seen by a doctor. The target was for patients to be seen within four hours of being admitted.

The response in some departments was simply to leave non-urgent patients to wait outside in ambulances. Patients still in the ambulance were not yet technically 'admitted' to the department, so the time in the ambulance did not count towards the four-hour target even though it was clearly detrimental to patient care.

6.8 Planning and conducting the audit of performance information

The first step is to **identify** the **objectives** against which the performance of the organisation is to be evaluated. The question the auditor seeks to answer is simply: is the organisation achieving its objectives?

Objectives will usually already have been determined by the organisation itself (or by a higher level of government). The organisation itself may already have determined its own specific numerical measures (KPIs). It may then be determined whether a targeted (aimed for) or standard (minimum acceptable) level of performance has been achieved on the basis of these measures. Alternatively, objectives can take the form of general verbal statements, such as 'to improve performance against quality indicators', from which numerical measures may then be derived by the auditor.

Having identified the objectives, the auditor plans **procedures** to test whether they have been achieved. The procedures used may include audit-type procedures, but may also involve an element of social-scientific research in the form of both quantitative and qualitative research methods.

Interactive question 5: Procedures

The Department of Transport of Proculsia is currently undertaking a large infrastructure project to build a new underground metro system in the country's second largest city, Pravus. The supreme auditor of Proculsia has been tasked with conducting a study of the Department's role in developing the project and funding it.

Considerable local media attention has been directed at the progress of the project, focusing on the report of a whistleblower who claimed that delays mean that it will not be completed on time. In response the Department has stated that the project will be completed within its budget of $14 billion, and by a deadline of five years' time.

Requirements

Identify procedures that should be performed in order to assess the following:

(a) The Department's management of its financial exposure on the project

(b) The Department's confidence that it will meet the prescribed project schedule

See **Answer** at the end of this chapter.

6.9 Concluding and reporting

The auditor expresses a conclusion on the entity's achievement of its objectives. There is no specific form of words that must be used.

The report may take the form of an **integrated report** of performance against the entity's objectives. Such a report would present the auditor's conclusion alongside the performance information itself. The conclusions of other audit processes may also be presented within the report, such as an audit conclusion on value for money.

If the auditors do not themselves produce the integrated report then it will be necessary for them to ensure that the performance information included in the report is consistent with the information on which they have given a conclusion.

Research carried out by ACCA in South Africa, where integrated reporting is mandatory for listed entities, suggests that although there is an appetite for third party assurance to be provided on integrated reports, the skills required, coupled with the associated costs and the limited areas on which assurance could actually be placed, do not suggest that this will be easy to implement (Maroun and Atkins, 2015).

Context example: Maternity services

In 2013 the National Audit Office (NAO) issued a report on maternity services in England. The report was an integrated report which presented audited Key Facts on maternity services, such as:

- 694,241 live births in England in 2012
- £2.6 billion – cost of National Health Service (NHS) maternity care in 2012–13
- 1 in 133 babies are stillborn or die within seven days of birth

The report gave an overview of maternity services, the organisations involved in delivering the services, and the government department's objectives for maternity care. As the government department had few of its own quantified measures of performance (there was a problem with the existence of information), the NAO developed its own measures.

Key Findings were presented for the performance of maternity services (performance information) and the management of maternity services. A conclusion was given on value for money, and recommendations were made for the relevant department.

The report contained details of the methodology used for the audit, the evidence base on which conclusions were based, and progress made by the department against recommendations made in the past.

The following paragraph was included within Key Findings, and is illustrative of the matters which auditors consider in reports such as this.

"Outcomes in maternity care are good for the vast majority of women and babies but, when things go wrong, the consequences can be very serious. In 2011, 1 in 133 babies were stillborn or died within seven days of birth. This mortality rate has fallen, but comparisons with the other UK nations suggest there may be scope for further improvement. There are wide unexplained variations in the performance of individual trusts [regional healthcare organisations] in relation to complication rates and medical intervention rates, even after adjusting for maternal characteristics and clinical risk factors. This variation may be partly due to differences in aspects of women's underlying health not included in the data and inconsistencies in the coding of the data."

(Source: *Maternity services in England*, © National Audit Office 2013, p. 8, para. 14)

The overall **conclusion** expressed is worth reading. It begins with a general conclusion (first paragraph below), and then outlines some difficulties found. It is noteworthy that one of the difficulties was that of measuring performance in this area.

"For most women, NHS maternity services provide good outcomes and positive experiences. Since 2007 there have been improvements in maternity care, with more midwifery-led units, greater consultant presence, and progress against the government's commitment to increase midwife numbers.

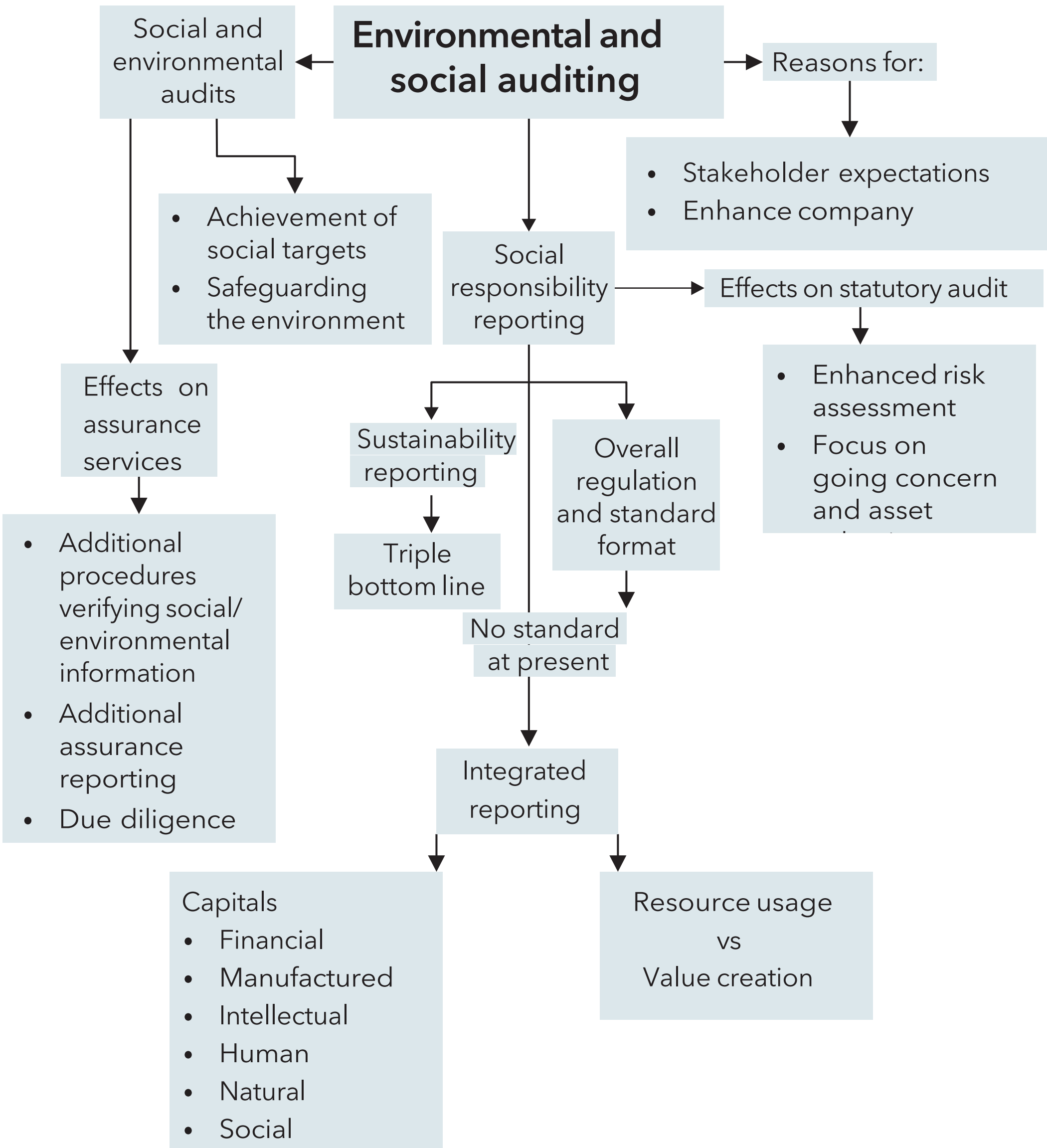
However, the Department's implementation of maternity services has not matched its ambition: the strategy's objectives are expressed in broad terms which leaves them open to interpretation and makes performance difficult to measure. The Department has not monitored progress against the strategy and has limited assurance about value for money. When we investigated outcomes across the NHS, we found significant and unexplained local variation in performance against indicators of quality and safety, cost, and efficiency. Together these factors show there is substantial scope for improvement and, on this basis, we conclude that the Department has not achieved value for money for its spending on maternity services."

(Source: *Maternity services in England*, © National Audit Office 2013, p. 40)

Professional skills focus: Applying judgement

Reviewing performance information should have demonstrated the importance of considering both quantitative and qualitative information when trying to assess something as complicated as a set of KPIs.

Summary



Environmental and social auditing
Social and environmental audits
Reasons for:
Stakeholder expectations
Enhance company
Achievement of social targets
Safeguarding the environment
Social responsibility reporting
Effects on statutory audit
Enhanced risk assessment
Focus on going concern and asset
Effects on assurance services
Additional procedures verifying social/ environmental information
Additional assurance reporting
Due diligence
Sustainability reporting
Triple bottom line
Overall regulation and standard format
No standard at present
Integrated reporting
Capitals
Financial
Manufactured
Intellectual
Human
Natural
Social
Resource usage
vs
Value creation

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Can you explain the term 'corporate responsibility' and why it is becoming increasingly important to companies and their stakeholders?
2.	Do you know what 'social responsibility' means and can you give some examples of how an organisation might demonstrate this?
3.	What is the impact that social and environmental factors might have on a set of financial statements and what does this mean for the auditor?
4.	Social and environmental audits may be undertaken by professional firms - do you know what such audits are and how they work?
5.	Can you discuss how a firm might undertake assurance work for a client in relation to its sustainability information?
6.	Do you know what integrated reporting means and how a firm might review a set of KPIs for an organisation and its operations?

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Chemico plc	This is a very typical illustration of how social and environmental matters can affect the audit and how separate reporting of such matters can be of benefit to a client. Attempting this question will help you understand how this topic could be examined.
Gooding and Brown plc	This question will also help you understand the various types of question that could be set for this topic. You will learn how to make best use of the scenario in an applied manner.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios that will help you improve your knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Larousse (board proposal)	A good illustration of how social responsibility is reported and how assurance can be provided in a complex scenario.
Kenyon requirement (2)	This is good practice for understanding the environmental impact of a set of circumstances on the financial statements - in this case, it is a contingent liability related to a chemical leak.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries.

Once you have attempted these questions, you can continue your studies by moving on to the next chapter.

Technical Reference

Maroun, W. and Atkins, J. (2015) *The Challenges of Assuring Integrated Reports: Views from the South African Auditing Community*. ACCA. [Online]. Available from: www.accaglobal.com/content/dam/ACCA_Global/Technical/integrate/ea-south-africa-IR-assurance.pdf [Accessed 27 May 2022].

Self-test questions

Answer the following questions

1 Chemico plc

You are the auditor of Chemico plc, a company which produces chemicals for use in household products. You are responsible for the planning of the audit for the year ended 31 December 20X8 and have attended a meeting with the finance director during which you have obtained the following information.

- Production had to be suspended during October 20X8 due to a strike by plant workers. Their main complaints were over working hours and the adequacy of health and safety procedures. The finance director has assured you that these issues have been dealt with.
- The company has received a letter from the environmental health department dated 10 January 20X9 indicating that samples taken from a nearby river have shown traces of a chemical which is harmful to wildlife. The environmental health department believes that Chemico plc is the source. The initial complaint was made by a landowner with fishing rights on the river. Chemico plc has denied responsibility.
- One of the products made by Chemico plc is to be withdrawn from use in household products under EU law. Chemico plc will therefore cease production of this chemical by 31 December 20X8 and the company has made plans to decommission this part of the plant. The directors anticipate that there may be a number of redundancies as a result and have included a provision for the estimated redundancy costs in the financial statements for the year ended 31 December 20X8.

Requirements

1.1 Identify and explain how social and environmental matters would affect the planning of the audit of Chemico plc.

1.2 The finance director is aware that other companies in his sector are including social responsibility reports as part of their corporate reports. He has asked you to clarify the requirement to include this type of information and to explain the benefits of doing so.

2 Gooding and Brown plc

Gooding and Brown plc (GB), a listed UK clothes retailer, has recently publicised GB World, a 10-year sustainability plan for the business. It focuses on many ecological and ethical issues, including the following:

(1) Fair trade – with commitments to ensuring the following:

(a) All raw materials used in GB materials fairly traded within six months

(b) Supply chain 100% fair trading within two years

(2) Waste – with commitments to ensuring all of the following:

(a) GB carrier bags are replaced by paper bags within one year

(b) Paper waste from GB operations to be 100% recycled within five years

(c) All waste from GB operations not to go to landfill within 10 years

(3) Climate change – with a commitment to making GB stores carbon neutral within 10 years

The board of directors intends to publish a report on the progress of the plan as part of its annual review which will be included in the document which contains the audited accounts.

The board has consulted with the audit engagement partner as to whether the firm might be able to provide a level of certification of progress with GB World annually.

Requirements

2.1 Outline whether the GB World plan will have any impact on future audits of Gooding and Brown plc.

2.2 Describe the matters the audit partner should consider in determining whether to accept an assurance engagement in relation to GB World.

2.3 Outline the evidence you would seek in respect of the commitments about waste, if such an engagement were accepted.

2.4 Discuss the current regulatory situation with regard to UK companies issuing sustainability reports.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

Potential benefits of social/environmental report to Westwitch plc

Westwitch plc is operating in three environmentally contentious areas. Its link with oil in Nigeria (scene of past human rights abuses) could damage its reputation (as BP's link with Chinese oil pipelines through Tibet). Nuclear waste disposal is an activity that could cause local hostility in South Africa, ethical hostility at home, and concern over the long-term financial implications of a health and safety disaster. As well as ethical and environmental concerns, working practices in developing countries could also endanger stakeholder relations.

By publishing a social and environmental report, Westwitch plc would be signalling that:

- it recognises the potential concerns of stakeholders; and
- it is attempting to address those concerns through a process of regular review and improvement.

Answer to Interactive question 2

Factors to consider

(1) **Recognition of a provision**

The auditor will need to determine whether the accounting treatment adopted by the company in respect of the costs of rectifying the environmental damage have been accounted for in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

In terms of recognition, any costs of environmental damage caused by the opening of the mine represent a current obligation as a result of a past event at the year-end date. The opening of the mine is the obligating event, so the fact that the costs do not need to be incurred until completion of mining is irrelevant. A provision should therefore be recognised.

As no mining has taken place, any environmental costs arising from the extraction of the mineral would not need to be provided for at the year-end date. Until mining actually commences there is no obligating event. Potentially management could avoid these costs by changing the entity's future operations. Instead a provision for these costs should be recognised as the mining progresses.

(2) **Measurement**

The amount of the provision recognised should represent the best estimate of the expenditure required to settle the obligation. The auditor will need to determine the basis on which management have calculated the amount of the provision and assess whether this is reasonable. Factors to consider might include:

- the expertise of those involved in estimating the costs;
- the cost of rectifying environmental damage on similar projects; and
- the reliability of previous estimates made by the company.

Answer to Interactive question 3

3.1 **Acceptance considerations**

There are four key things that the audit engagement partner should consider:

(1) **Impact of the new engagement on the audit**

The audit engagement partner needs to ensure that the **objectivity of the audit is not adversely affected** by accepting any other engagements from an audit client. This is of primary importance.

Factors that they will consider include the impact that any fees from the engagement will have on total fees from the client and what staff will be involved in carrying out the new engagement (ie, will they be audit staff, or could the engagement be carried out by a different department).

In favour of the engagement, they would consider that such an engagement should increase their knowledge of the business and its suppliers and systems, and might enhance the audit firm's understanding of the inherent audit risk attaching to the business.

(2) **Competence of the audit firm to carry out the assignment**

The audit engagement partner needs to consider whether the firm has the **necessary competence** to carry out the engagement in a quality manner, so as to minimise the risk of being sued for negligence. This will depend on the nature of the engagement and assurance required (see below) and on whether the auditor felt it would be cost effective to use the work of an expert, if required.

(3) **Potential liability of the firm for the report**

As the engagement is not an audit engagement, the partner should consider to whom he would be **accepting liability** in relation to this engagement, and whether the risk that that entails is worth it, in relation to the potential fees and other benefits of doing the work (such as keeping an audit client happy, and not exposing an audit client to the work of an alternative audit firm).

Unless otherwise stated, liability is unlikely to be restricted to the shareholders for an engagement such as this; indeed, it is likely to extend to all the users of the annual report. This could include the following:

- The bank
- Future investors making ethical investing decisions
- Customers and future customers making ethical buying decisions

The partner should also consider whether it might be possible to limit the liability for the engagement, and **disclaim liability** to certain parties.

(4) **Nature of the engagement/criteria/assurance being given**

Before the partner accepted any such engagement on behalf of the firm, he should **clarify** with the directors the **exact nature** of the engagement, the degree of assurance required and the criteria by which the directors expect the firm to assess the assertions.

As the engagement is not an audit engagement, the audit rules of 'truth and fairness' and 'materiality' do not necessarily apply. The partner should determine whether the directors want the firm to verify that the assertions are 'absolutely correct' or 'correct in x% of cases' and also what quality of evidence would be sufficient to support the conclusions drawn – for example, confirmations from suppliers, or legal statements, or whether the auditors would have to visit suppliers and make personal verifications.

This engagement might be less complex for the audit firm if they could conduct it as an 'agreed-upon procedures' engagement, rather than an assurance engagement.

3.2 Assertions

(1) Animal testing

The assertion is complex because it does not merely state that products sold have not been tested on animals, but that ingredients in the products have not been tested on animals.

This may mean a series of links have to be checked, because Naturascope's supplier who is the manufacturer of one of its products may not have tested that product on animals, but may source ingredients from several other suppliers, who may in turn source ingredients from several other suppliers, etc.

The audit firm may also find that it is a subjective issue, and that the assertion "not tested on animals" is not as clear cut as one would like to suppose. For example, the dictionary defines 'animal' as either "any living organism characterised by voluntary movement …" or "any mammal, especially man". This could suggest that the directors could make the assertion if they didn't test products on mammals, and it might still to an extent be 'true', or that products could be tested on 'animals' that, due to prior testing, were paralysed. However, neither of these practices are likely to be thought ethical by animal lovers who are trying to invest or buy ethically.

Potential sources of evidence include: assertions from suppliers, site visits at suppliers' premises and a review of any licences or other legal documents in relation to testing held by suppliers.

(2) Child labour

This assertion is less complex than the previous assertion because it is restricted to Naturascope's direct overseas suppliers.

However, it contains complexities of its own, particularly the definition of 'child labour', for example in terms of whether labour means 'any work' or 'a certain type of work' or even 'work over a set period of time', and what the definition of a child is, when other countries do not have the same legal systems and practical requirements of schooling, marriage, voting etc.

There may also be a practical difficulty of verifying how old employees actually are in certain countries, where birth records may not be maintained.

Possible sources of evidence include: assertions by the supplier and inspection by auditors.

(3) Recycled materials

This may be the simplest assertion to verify, given that it is the least specific. All the packaging must have an element of recycled materials. This might mean that the assertion is restricted to one or a few suppliers. The definition of packaging may be wide; for example, if all goods are boxed and then shrink-wrapped, it is possible that those two elements together are termed 'packaging' and so, only the cardboard element need contain recycled materials.

The sources of evidence are the same as previously – assertions from suppliers, inspections by the auditors or review of suppliers' suppliers to see what their methods and intentions are.

Answer to Interactive question 4

At first glance, North Hospital may appear to have the worse mortality rate, with 23 deaths compared with 19 at South Hospital. These absolute figures may be misleading, however, so it is necessary to calculate the **relative** mortality rates for each hospital:

North Hospital = 23 / 763 = 3.0%

South Hospital = 19 / 549 = 3.5%

On this basis, North appears to be the better performing hospital. On further investigation, however, the picture becomes more complex.

Adjusting for emergency patients

It is likely that emergency procedures carry a higher risk of death than planned procedures. An uneven distribution of emergency procedures between the two hospitals would indicate different risk profiles in each hospital's underlying patient population for the period, which would be expected to affect the mortality rate for each hospital.

At North Hospital, 12 patients died during planned procedures, which gives a mortality rate of 2.0% (12/610) for planned procedures.

At South Hospital, seven patients died during planned procedures, which gives a mortality rate of 1.4% (7/494) for planned procedures.

After adjusting for emergency procedures, it would appear that South Hospital has the lower (better) mortality rate. This appears to indicate that South Hospital is performing better for ordinary planned procedures.

It should be noted, however, that South Hospital has a much higher mortality rate for emergency procedures:

North Hospital: (23 – 12) / (763 – 610) = 11 / 153 = 7%

South Hospital: (19 – 7) / (549 – 494) = 12 / 55 = 22%

This could be indicative of problems at South Hospital in relation to emergency procedures. It may also be a sign of differences in the underlying populations. Further information on the types of patients operated on in each hospital would be needed in order to determine which performed better in emergency situations.

Answer to Interactive question 5

(a) Procedures include the following:

Review overall project expenditure and compare with budgeted expenditure

- Interview relevant management and staff to determine reasons for any variations from budget
- Interview key management and staff to identify their expectations of whether the project will be completed within budget
- Analyse the Department's business case for the project to determine whether the planned expenditures will meet the overall aims of the project

(b) Review project timetable and compare progress with planned schedule

- In relation to the whistleblower's claim, identify the delays referred to and ascertain the impact these are likely to have on the timetable
- Interview key management and staff to identify their expectations of whether the project will be completed on time, and in particular what the effect may be of any delays already experienced
- Ascertain any knock-on effects that the delays may have, and inquire of management what actions they have taken to mitigate these effects
- Review of results of any internal challenges to management in relation to the delays, ie, how management responded

Answers to Self-test questions

1 Chemico plc

1.1 Key issues

The key issues which would need to be addressed in planning the audit of Chemico plc include the following:

Understanding the entity

The chemical production industry is highly regulated and as such the business is likely to be subject to a wide range of regulation including both environmental and health and safety. The auditor would need to have an awareness of these if they are to have a good understanding of the business.

Risk assessment

The nature of the industry in which Chemico plc operates is particularly risky in terms of its compliance with regulation. This risk assessment will be affected by the following factors:

- Whether there is a history of penalties and legal proceedings against the company. A review of previous years' files should provide information together with discussions with members of staff involved in previous audits.
- The entity's attitude towards these matters. Chemico plc has experienced problems in both environmental matters and health and safety during 20X8 which may indicate poor governance.
- The likelihood of the existence of other related problems. While a number of issues have been identified there is a risk that other breaches exist which have not yet been identified, particularly if poor practice is widespread.

The impact of the strike. Issues include the following:

- Whether the working hours complained of constituted a breach in employment law and health and safety
- Whether the lack of adequate safety procedures has resulted in any accidents leading to litigation
- Whether the issues have genuinely been resolved so that any breaches of regulations are not ongoing
- Whether the company is liable to be fined and/or sued as a result
- Whether any fines or penalties have been properly accounted for or provided for

The contamination of the river Issues include the following:

- Whether the leak constitutes an adjusting event after the reporting period. Although the letter has been received after the year end it is likely that, if responsible, any leak from Chemico plc occurred before the year end. The financial statements would need to be adjusted for the consequences.
- The likelihood of Chemico plc being responsible for the leak. The audit plan would include procedures to review the evidence held by Chemico plc and any legal correspondence which might indicate the likely outcome.

- The potential size of any penalty including any compensation claim from the landowner, as this may have an impact on the viability of the business.

Withdrawn product

- There is a risk that items of plant may be impaired as a result of the withdrawn product. Audit procedures will be required to identify the assets affected and to ensure that they have been written down to their recoverable amount.
- If assets are to be sold they should be classified and accounted for as held for sale in accordance with IFRS 5.
- The audit plan will need to include procedures to ensure that any other costs associated with the shut-down of this part of production have been identified and provided for in accordance with IAS 37.
- Audit procedures will be required to determine whether the provision for redundancies should be recognised. If the cessation of the production constitutes a restructuring in accordance with IAS 37 and a constructive obligation exists the redundancy costs would be recognised in 20X8. In this case there is no indication of any announcement of the redundancies, in which case a provision should not be made.
- The overall impact of the withdrawal on the viability of the business will need to be considered.

1.2 There is currently no requirement in law to provide social responsibility information beyond that required in the Strategic Report under Companies Act 2006. Many companies go beyond this minimum requirement and produce a separate corporate responsibility report. There is no consensus as to what that information should contain. In practice, however, it is becoming more common with many companies following the guidance issued by the Global Reporting Initiative.

The benefits of providing this type of information include the following:

- It is an indication that the company is well run and that governance issues are taken seriously. This enhances the reputation of the company with investors, employees and the general public.
- Abuses of the environment and/or human rights can damage the reputation of the company and therefore affect the share price.
- Potential investors want to be able to measure the performance of a company in a number of different ways, not necessarily just financial performance. This information helps investors make ethical decisions.
- As this type of information becomes more common it may appear that companies who do not provide it are failing to meet social and environmental standards.

2 Gooding and Brown plc

2.1 Impact on the audit

Inclusion of statement in annual report

The GB World plan will directly affect the audit in the sense that the directors plan to report on it in each annual report and the auditors will therefore have a duty to ensure that there are no material misstatements or inconsistencies between the GB World information and audited information contained within the annual report in accordance with ISA 720 (Revised November 2019), *The Auditor's Responsibilities Relating to Other Information*.

Impact on financial statements

In addition, the GB World plan has the potential to impact on various aspects of the financial statements, and therefore the audit, although the degree of materiality of the impacts will differ.

(1) **Commitment to be a fair trader**

This commitment will impact on **inventory value and gross margins** (if clothing that does not meet the criteria has to be divested quickly) and on **supply systems** and chains.

Inventory at risk of becoming obsolete after six months might be sold in the normal course of business. If not, it is likely to be sold at an unusually low margin as sale items to ensure that the commitment is met, and this sale might be larger than the sales the company (and therefore) auditors are accustomed to, causing changes in sales and gross margin patterns.

A potential risk is any **legal issues** caused if GB were to break any contracts with suppliers who did not meet their ethical criteria. The longer lead time of two years is unlikely to make this happen, as they are unlikely to have such onerous contracts that they cannot be divested over a two-year period, but if contracts were changed in order to meet the six-month deadline, then the company might have to make provision for settlements in the next financial statements.

Assuming adequate controls are in place over the supply chain, any changes in supply over the longer period of two years should also not impact the financial statements unduly.

This commitment has a potential impact on **costs** too – switching to fair trade implies an increase in basic product cost. The auditors should be aware of this and assess the context in terms of whether there is shareholder expectation of certain **profit targets**, regardless of the GB World plan, as this could lead to pressure on management in respect of the results.

Lastly, the auditor should bear in mind customer expectation concerning the GB World plan and monitor the impact the plan has on operations. It is probable that the board of directors is responding to the perceived desire of its shoppers in terms of ethical and environmental friendliness. Given the possible increase in cost that these commitments entail, if the board has misjudged the desire of the consumer, the GB World plan could result in lost custom, and reduced sales. Alternatively, given the long timescale that some aspects of the GB World plan have, customers might become impatient for change and transfer loyalty to a retailer that has a similar plan but is working faster towards the same aims. In the extreme, both these situations could lead to **going concern** issues for Gooding and Brown.

(2) **Commitment to changing waste patterns**

Waste disposal is likely to impact the statement of profit or loss and other comprehensive income in the form of annual expenses. There may be some fluctuations in cost of which the auditors should be aware.

(3) **Commitment to be carbon neutral**

The issue with the largest potential impact on the financial statements is the commitment to make the company carbon neutral. It may be possible to achieve this objective simply by changing energy supply and type, but it might also be necessary to make changes to existing assets to achieve this objective. For example, the company might have to make use of solar panels and windmills, in which case there will be non-current asset additions for the auditor to consider. Alternatively, GB might own premises which it would be difficult to carbon neutralise, which might involve moving premises, hence sales of assets and possible construction of carbon neutral premises, hence construction of assets.

2.2 **Matters to consider in respect of assurance engagement**

(1) **Ethical**: The key issue to consider is whether it is possible to accept any other engagement in relation to Gooding and Brown and maintain audit independence. This will depend on factors such as the amount of 'other' work already carried out for Gooding and Brown, the staff and partners that would be involved in any assurance work and whether they were separated from the audit team and Gooding and Brown's status itself. With regard to the latter, for example, Gooding and Brown is a listed company therefore specific conditions within the FRC Ethical Standard must be applied.

(2) **Nature of the engagement/criteria/assurance being given**: Before the partner accepts any such engagement on behalf of the firm, he should **clarify** with the directors the **exact nature** of the engagement, the degree of assurance required and the criteria by which the directors expect the firm to assess any assertions made in the annual report. At present the commitments seem very general and vague but, if there is a more detailed underlying plan, there might be more scope for the audit firm to provide an assurance engagement.

As the engagement is not an audit engagement, the audit rules of 'truth and fairness' and 'materiality' do not necessarily apply. The partner should determine whether the directors want the firm to verify that any assertions are 'absolutely correct' or 'correct in x% of cases' and also what quality of evidence would be sufficient to support the conclusions drawn – for example, confirmations from suppliers, or legal statements, or whether the auditors would have to visit suppliers and make personal verifications.

This engagement might be less complex for the audit firm if it could conduct it as an 'agreed-upon procedures' engagement, rather than an assurance engagement.

(3) The firm also needs to consider the following:

(a) Whether the firm has the appropriate skills to undertake the work (are they experts in renewable energy?)

(b) What liability they would incur as a result of the work and to whom (this is unlikely to be limited to shareholders as a result of the number of people who have access to the annual report and the fact that there is no legal precedent for restricting liability solely to the shareholders in respect of this type of work)?

2.3 **Sources of evidence**

Potential sources of evidence with regard to the waste commitments:

- Contracts/invoices with waste removal companies/recycling companies
- Contracts/invoices with bag supplier(s)
- Store inspection to observe bags used in stores
- Inspection of waste disposal

2.4 **Current regulatory situation with regard to sustainability reports**

There is currently **no consensus** on the type of information that should be disclosed in a sustainability report. Historically, companies whose activities have the greatest social and environmental impact have been the most active in developing this type of reporting, for example companies within the oil and gas industry like Shell. In more recent years **sustainability reporting has become more common** but guidance is still developing.

An increasing number of companies are following guidance issued by the **Global Reporting Initiative** (GRI). The GRI aims to develop **transparency, accountability, reporting and sustainable development**. Its vision is that reporting on economic, environmental and social issues should become as routine and comparable as financial reporting. In addition, the Companies Act 2006 now requires most companies to include information on environmental, employment, social and community issues in a strategic report. From October 2013 reporting on greenhouse gas emissions has been mandatory for quoted companies.

Chapter 27

Internal auditing

Introduction

Learning outcomes

- Evaluate the role of internal audit and design appropriate procedures to achieve the planned objectives

Specific syllabus reference for this chapter is: 17(a)

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	**Role of internal audit** This is a recap of what you have previously learned about internal audit.	**Approach** This should be revision, but make sure it all sounds familiar before you move on. **Stop and think** Did you know that internal auditors helped to uncover the WorldCom scandal?	Should an exam question ask you to discuss the work of the internal auditor, the contents of this section are the best place to start.	**IQ1: Internal and external audit** Try this question to see if you can differentiate the work of internal and external auditors.
2	**Regulation** You may be surprised to learn that internal audit has its own form of regulation - what do you think it includes?	**Approach** Run through the various codes and standards. **Stop and think** What differences can you see between the regulatory regimes for internal and external auditors?	There is a chance that a question might ask you how to evaluate an internal audit function within a scenario, so make sure you can apply the various standards and code principles if required.	**IQ2: Ethics** This is good experience of applying ethical theories in a more practical situation.
3	**Scope of internal audit** Internal audit has a key role to play in the management of risk.	**Approach** Try and apply the knowledge in this section to what you learned in the chapter on Corporate Governance.	When answering questions on risk management as part of corporate governance, don't forget to consider the role that internal audit could	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive questions
		Stop and think How do you think internal auditors might combat fraud and manage risk in the real world?	play in promoting best practice.	
4	**Internal audit assignments** A quick recap of the various pieces of work that internal audit may be asked to perform.	**Approach** Read through each of these and consider how the internal auditor would actually perform each one. **Stop and think** Have you ever been involved in any of these types of activity?	Regardless of the scenario or the assignment given, if a question requires you to discuss this type of work, make sure you remember that it is for internal not external audit purposes and tailor your answer accordingly.	N/A
5	**Multi-site operations** Acting as internal auditor for an entity that is spread across many different locations brings its own challenges.	**Approach** To help you engage with this section, pick a suitable organisation that you are familiar with to help visualise the challenges associated with performing internal audit tasks across multiple sites. **Stop and think** Other than a retailer, what else operates over several locations?	If tested, make sure your answers consider the practical aspects associated with operating over many different sites.	**IQ3: Multi-site operations** This is a very practical illustration of how to organise a finite resource over a number of different locations.
6	**Internal audit reporting** How does internal audit make sure that its voice is heard?	**Approach** Read through this section and consider the differences in reporting between internal and external auditors.	Remember that the report produced by internal auditors does not have to follow any set format, so it should be very practical and specific to achieve whatever	N/A

Topic	Practical significance	Study approach	Exam approach	Interactive questions
		Stop and think Internal auditors could be asked to review anything, so reporting could take a number of different forms.	the desired audit objectives are.	

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Role of internal audit

Section overview

- Internal audit helps management to achieve the corporate objectives.
- It plays a key role in assessing and monitoring internal control policies and procedures.
- There are a number of key differences between internal and external audit.

1.1 Introduction

You have already been introduced to the concept of internal audit and the use of the internal audit function by the external auditor in your earlier studies. ISA 610 (Revised 2013), *Using the Work of Internal Auditors* was covered in Chapter 6.

At the Advanced Level you are expected to have a broader understanding of the topic and to be able to apply your knowledge to more complex situations.

You are also expected to be able to consider the role of internal audit in its own right within the business. This will be the main focus of this chapter.

1.2 Internal audit

Definition

Internal audit function: A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes (ISA 610.14).

Internal audit departments are normally a feature of larger organisations. They help management to achieve the corporate objectives and are an essential feature of a good corporate governance structure (corporate governance including audit committees is covered in Chapter 4). This is highlighted by the fact that the UK Corporate Governance Code states that companies with a premium listing without an internal audit function should annually review the need to have one. The need for internal audit will depend on the following factors:

- The **scale, diversity and complexity** of the company's activities
- The **number of employees**
- **Cost-benefit considerations**
- **Changes** in the organisational structures, reporting processes or underlying information systems
- **Changes** in **key risks**
- **Problems** with **internal control systems**
- An **increased number** of **unexplained** or **unacceptable** events

Internal audit can play a key role in assessing and monitoring internal control policies and procedures.

The internal audit function can help the board in other ways as well:

- by, in effect, acting as auditors for board reports not audited by the external auditors;
- by being the experts in fields such as auditing and accounting standards in the company and helping with the implementation of new standards; and

- by liaising with external auditors, particularly where external auditors can use internal audit work and reduce the time and therefore cost of the external audit (although using internal auditors for ' direct assistance' on the external audit is **prohibited** in some jurisdiction such as in the UK under). In addition, internal audit can check that external auditors are reporting back to the board everything they are required to under auditing standards.

1.3 WorldCom

The importance of internal audit in achieving good corporate governance can also be seen in the role it had to play in bringing to light the WorldCom scandal.

Cynthia Cooper, who was the Vice President for internal auditing at the time, has been credited with uncovering the fraud and reporting it to the board of directors. Together with her team she uncovered that billions of dollars of operating costs had been capitalised, turning a $662 million loss into a $1.4 billion profit in 2001. This was in spite of being told by the company's auditors, Arthur Andersen and the Chief Financial Officer that there were no problems. On 12 June 2002 she revealed her findings to the head of the audit committee. Such was the magnitude of her actions that she was named *The Times* person of the year for 2002.

1.4 Objectives of internal audit

The role of the internal auditor has expanded in recent years as internal auditors seek to monitor all aspects (not just accounting) of organisations, and add value to their employers. The work of the internal auditor is still prescribed by management, but it may cover the following broad areas.

(a) **Review of the accounting and internal control systems**. The establishment of adequate accounting and internal control systems is a responsibility of management and the directors. Internal audit is often assigned specific responsibility for the following tasks.

- Reviewing the design of the systems
- Monitoring the operation of the systems by risk assessment and detailed testing
- Recommending cost-effective improvements

Review will cover both financial and non-financial controls.

(b) **Examination of financial and operating information**. This may include review of the means used to identify, measure, classify and report such information and specific inquiry into individual items, including detailed testing of transactions, balances and procedures.

(c) **Review of the economy, efficiency and effectiveness** of operations.

(d) **Review of compliance** with laws, regulations and other external requirements and with internal policies and directives and other requirements including appropriate authorisation of transactions.

(e) **Review of the safeguarding of assets**. Are valuable, portable items such as computers and cash secured, is authorisation needed for dealing in investments?

(f) **Review of the implementation of corporate objectives**. This includes review of the effectiveness of planning, the relevance of standards and policies, the organisation's corporate governance procedures and the operation of specific procedures such as communication of information.

(g) **Identification of significant business and financial risks, monitoring the organisation's overall risk management policy** to ensure it operates effectively, and **monitoring the risk management strategies** to ensure they continue to operate effectively.

(h) **Special investigations** into particular areas, for example suspected fraud.

1.5 Differences between internal and external audit

Internal auditors are **employees** of the organisation whose work is designed to add value and who normally report to an **audit committee** where one exists and, if not, to the board of directors. External auditors are from accountancy firms and their role is to report on the financial statements to **shareholders**.

Both internal and external auditors review controls, and external auditors may place reliance on the internal auditors' work as you are aware from your previous studies.

The difference in each set of auditors' **objectives** is important however: every definition of internal audit suggests that it has a much **wider scope** than external audit, which only has the objective of considering whether the accounts give a true and fair view of the organisation's financial position.

Interactive question 1: Internal and external audit

The growing recognition by management of the benefits of good internal control, and the complexities of an adequate system of internal control, have led to the development of internal auditing as a form of control over all other internal controls. The emergence of internal auditors as specialists in internal control is the result of an evolutionary process similar in many ways to the evolution of external auditing.

Requirement

Explain why the internal and external auditors' review of internal control procedures differ in purpose.

See **Answer** at the end of this chapter.

2 Regulation

Section overview

- The Institute of Internal Auditors issue a Code of Ethics and International Standards for the Professional Practice of Internal Auditing.
- The Code of Ethics includes principles and rules of conduct.
- There are two categories of standard:
  - Attribute standards
  - Performance standards

2.1 Institute of Internal Auditors

Internal auditing is not regulated in the same way that statutory audit is. There are no legal requirements associated with being an internal auditor and the scope and nature of the internal auditor's work is more likely to be set by company policy than by external guidelines.

The FRC and IAASB do not issue detailed auditing standards in relation to internal audit work. Where they are applicable, the standards set out in Auditing Standards are likely to be good practice, but they are not prescriptive in the same way that they are for external auditors.

In contrast to external auditors, internal auditors are not required to be members of a professional body such as ICAB. However, this does not mean that they cannot be, and many are. There is also a global Institute of Internal Auditors (IIA) which internal auditors may become members of. This aims to represent, promote and develop the professional practice of internal audit. Currently it has 180,000 members in 190 countries worldwide. The IIA has issued mandatory guidance in the form of its **Code of Ethics** and **International Standards for the Professional Practice of Internal Auditing**.

2.2 Code of Ethics

The purpose of the Code of Ethics is to promote an ethical culture in the profession of internal auditing. It includes two components:

(a) Principles

(b) Rules of conduct

2.2.1 Principles

These are defined by the IIA as follows:

Integrity	The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgement.
Objectivity	Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all the relevant circumstances and are not unduly influenced by their own interests or by others in forming judgements.
Confidentiality	Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so.
Competency	Internal auditors apply the knowledge, skills and experience needed in the performance of internal audit services.

2.2.2 Rules of conduct

These describe in more detail the behaviour expected of the internal auditor. The key points are as follows:

(a) **Integrity**

Internal auditors shall perform their work with honesty, diligence and responsibility. They shall observe the law and not knowingly be party to any illegal activity. The ethical objectives of the IIA should be respected.

(b) **Objectivity**

Internal auditors shall not:

- participate in any activity or relationship; or
- accept anything.

that may impair or be seen to impair their objectivity.

Any facts known to them which may distort the reporting of activities should be disclosed.

(c) **Confidentiality**

Internal auditors shall be prudent in their use of confidential information and should not use it for personal gain.

(d) **Competency**

Internal auditors shall only provide services for which they have the relevant knowledge, skills and experience and should continually strive to improve the quality of their service. Work should be performed in accordance with International Standards for the Professional Practice of Internal Auditing (see below).

Interactive question 2: Ethics

Explain the reasons why internal auditors should or should not report their findings on internal control to the following company officials:

(a) The board of directors

(b) The chief accountant

See **Answer** at the end of this chapter.

2.3 International Standards for the Professional Practice of Internal Auditing

The IIA states that the purpose of the International Standards for the Professional Practice of Internal Auditing is to:

- delineate **basic principles** that represent the practice of internal auditing;
- provide a **framework** for performing and promoting a broad range of value-added internal auditing;
- establish the **basis for the evaluation of internal audit performance**; and
- foster **improved organisational processes and operations**.

There are two categories of standard which apply to all internal audit services:

(a) **Attribute standards**

These address the **characteristics** of organisations and parties performing internal audit activities.

(b) **Performance standards**

These describe the **nature of internal audit activities** and provide quality criteria against which the performance of these services can be evaluated.

These were revised in October 2016 and are effective from January 2017. Implementation standards apply to specific types of internal audit activity.

2.3.1 Attribute standards

These are summarised as follows:

Purpose, authority and responsibility	The purpose, authority and responsibility of the internal audit activity must be formally defined in an internal audit charter, consistent with the Mission of Internal Audit, and the mandatory elements of the International Professional Practices Framework (the Core Principles for the Professional Practice of Internal Auditing, the Code of Ethics, the Standards, and the definition of Internal Auditing).
Independence and objectivity	The internal audit activity must be independent, and internal auditors must be objective in performing their work. In particular: • the chief audit executive must report to a suitably senior level within the organisation; • conflicts of interest must be avoided; and • internal auditors must refrain from assessing specific operations for which they were previously responsible.

Proficiency and due professional care	Engagements must be performed with proficiency and due professional care. • The chief audit executive must obtain competent advice and assistance if the internal auditors lack the necessary skills to perform all or part of an engagement. • Internal auditors must have sufficient knowledge to evaluate the risk of fraud and the manner in which it is managed by the organisation but are not expected to be experts in detecting and investigating fraud. Internal auditors must exercise due professional care by considering the: • extent of the work needed to achieve the engagement's objectives; • relative complexity, materiality, or significance of matters to which assurance procedures are applied; • adequacy and effectiveness of governance, risk management and control processes; • probability of significant errors, fraud, or non-compliance; and • cost of assurance in relation to potential benefits.
Quality assurance and improvement programme	The chief audit executive must develop and maintain a quality assurance and improvement programme that covers all aspects of the internal audit activity. A quality assurance and improvement programme is designed to enable an evaluation of the internal audit activity's conformance with the Standards and of whether internal auditors apply the Code of Ethics. The programme also assesses the efficiency and effectiveness of the internal audit activity and identifies opportunities for improvement. The chief audit executive should encourage board oversight in the quality assurance and improvement programme. Both internal and external assessments of the performance of the internal audit activity must be conducted.

2.3.2 Performance standards

These are as follows:

Managing the internal audit activity	The chief audit executive must effectively manage the internal audit activity to ensure it adds value to the organisation. In particular: • the internal audit plan of engagement must be based on a risk assessment performed at least annually; and • these plans must be communicated to senior management and to the board for review and approval.

Nature of work	The internal audit activity must evaluate and contribute to the improvement of governance, risk management and control processes using a systematic, disciplined and risk-based approach. It must: • evaluate risk exposures relating to the organisation's governance, operations and information systems; • help and evaluate the effectiveness and efficiency of controls, promoting continuous improvement; and • assess and make recommendations regarding governance processes.
Engagement planning	Internal auditors must develop and document a plan for each engagement, including the scope, objectives, timing and resource allocations. Planning considerations must include the following: • The strategies and objectives of the activity being reviewed and the means by which the activity controls its performance • The significant risks to the activity's objectives, resources and operations and the means by which the potential impact of risk is kept to an acceptable level • The adequacy and effectiveness of the activity's governance, risk management and control processes compared to a relevant control framework or model • The opportunities for making significant improvements to the activity's risk management and control processes
Performing the engagement	Internal auditors must identify, analyse, evaluate and document sufficient information to achieve the engagement's objectives. Engagements must be properly supervised to ensure that objectives are achieved, quality is assured and staff are developed.
Communicating results	Internal auditors must communicate the engagement results. Communications must be accurate, objective, clear, concise, constructive, complete and timely. Corrected information must be circulated in instances where significant errors or omissions are identified.
Monitoring progress	The chief audit executive must establish and maintain a system to monitor the disposition of results communicated to management. There must be a follow-up process to ensure that management actions have been effectively implemented or that senior management has accepted the risk of not taking action.
Communicating the acceptance of risks	When the chief audit executive concludes that senior management has accepted a level of residual risk that may be unacceptable to the organisation, the chief audit executive must discuss the matter with senior management. If the decision regarding residual risk is not resolved, the chief audit executive must communicate the matter to the board.

Professional skills focus: Structuring problems and solutions

The various code principles and other standards show you how such a framework can be applied to help evaluate an internal audit function if required.

3 Scope of internal audit

Section overview

- Internal audit has two key roles to play in relation to risk management:
  - Ensuring the company's risk management system operates effectively
  - Ensuring that strategies implemented in respect of business risks operate effectively
- Internal auditors may have a role in preventing and detecting fraud.

3.1 Business risk

Generally board and management are responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. This will include business risks. As we have seen in Chapter 5, this is the risk inherent to the company in its operations and encompasses risk at all levels of the business.

Business risk cannot be eliminated, but it must be managed by the company.

Identify risks → Determine company policy → Implement strategy

Designing and operating internal control systems is a key part of a company's risk management. This will often be done by employees in their various departments, although sometimes (particularly in the case of specialised computer systems) the company will hire external expertise to design systems.

3.2 The role of internal audit

The internal audit department has a twofold role in relation to risk management.

- It monitors the company's **overall risk management policy** to ensure it operates effectively.
- It monitors the **strategies implemented** to ensure that they continue to operate effectively.

Going back to the diagram used earlier, this can be shown as:

As a major risk management policy in companies is to implement strong internal controls in order to reduce risks, internal audit has a key role in **assessing systems and testing controls**.

Internal audit may help with the development of systems. However, its key role will be in **monitoring the overall process** and in providing assurance that the systems which the departments have designed meet objectives and operate effectively.

It is important that the internal audit function retains its **objectivity** towards these aspects of its role, which is another reason why internal audit would generally not be involved in the assessment of risks and the design of the system.

3.3 Responsibility for fraud and error

Fraud is a key business risk. It is the responsibility of the **directors and management** to prevent and detect fraud. As the internal auditor has a role in risk management, they are involved in the process of managing the risk of fraud.

The internal auditor can help to prevent fraud by carrying out work on assessing the adequacy and effectiveness of control systems. The internal auditor can help to detect fraud by being mindful when carrying out their work and reporting any suspicions.

The very existence of an internal audit function may act as a deterrent to fraud. The internal auditors might also be called upon to undertake special projects to investigate a suspected fraud.

Professional skills focus: Applying judgement

Being able to assess risks (including business risks) is always a good way of demonstrating that you possess sound judgement skills.

4 Internal audit assignments

Section overview

- Internal audit can be involved in many different assignments as directed by management.
- These include the following:
  - Value for money audits
  - IT audits
  - Best value audits
  - Financial audits
  - Operational audits

4.1 Value for money

Value for money (VFM) audits examine the **economy, efficiency and effectiveness** of activities and processes. These are known as the three Es of VFM audits. This topic is referred to in Audit and Assurance at the Professional Level in the context of public sector auditing. The following is a summary of the key points.

4.1.1 The three Es

Definitions

Economy: Attaining the appropriate quantity and quality of physical, human and financial resources (inputs) at lowest cost. An activity would not be economic if, for example, there was overstaffing or failure to purchase materials of requisite quality at the lowest available price.

Efficiency: This is the relationship between goods or services produced and the resources used to produce them (process). An efficient operation or process produces the maximum output for any given set of resource inputs, or it has minimum inputs for any given quantity and quality of product or service provided.

Effectiveness: This is concerned with how well an activity is doing in achieving its policy objectives or other intended effects (outputs).

The internal auditors will evaluate these three factors for any given business system or operation in the company. Value for money can often only be judged by comparison. In searching for value for money, present methods of operation and uses of resources must be compared with alternatives.

4.1.2 Selecting areas for investigation

Value for money checklists can be used. The following list identifies areas of an organisation, process or activity where there might be scope for significant value for money improvements. Each of these should be reviewed within individual organisations.

- Service delivery (the actual provision of a public service)
- Management process
- Environment

An alternative approach is to look at areas of spending. A value for money assessment of economy, efficiency and effectiveness would look at whether:

- too much money is being spent on certain items or activities to achieve the targets or objectives of the overall operation;
- money is being spent to no purpose because the spending is not helping to achieve objectives; and
- if changes could be made to improve performance.

An illustrative list is shown below of the sort of spending areas that might be looked at, and the aspects of spending where value for money might be improved.

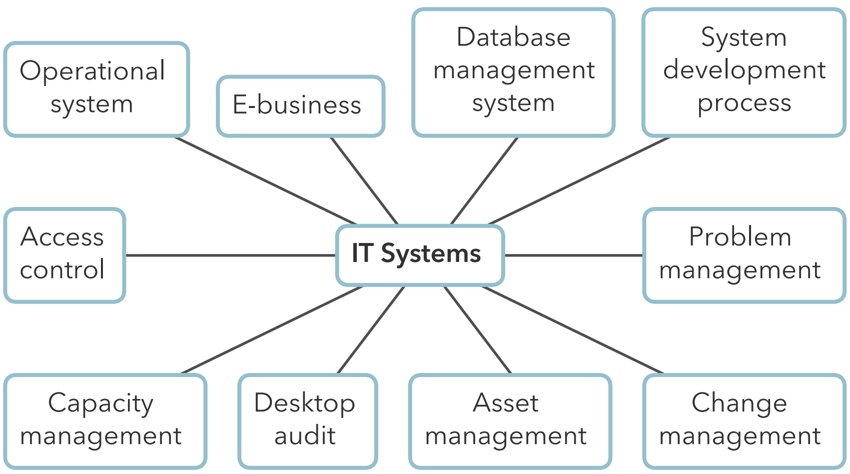
- Employee expenses
- Premises expenses
- Suppliers and services
- Establishment expenses
- Capital expenditure

4.2 Information technology

An information technology (IT) audit is a **test of control in a specific area of the business**, the computer systems. Increasingly in modern business, computers are vital to the functioning of the business, and therefore the controls over them are key to the business.

It is likely to be necessary to have an IT specialist in the internal audit team to undertake an audit of the controls, as some of them will be programmed into the computer system.

Figure 27.1: IT systems



4.3 Financial

The financial audit is internal audit's **traditional role**. It involves reviewing all the available evidence (usually the company's records) to substantiate information in management and financial reporting.

This role in many ways echoes the role of the external auditor, and is not a role in which the internal auditors can add any particular value to the business. Increasingly, it is a minor part of the function of internal audit.

4.4 Operational audits

Definition

Operational audits: Audits of the operational processes of the organisation. They are also known as management and efficiency audits. Their prime objective is the monitoring of management's performance, ensuring company policy is adhered to.

There are two aspects of an operational assignment:

- Ensure policies are **adequate**
- Ensure policies work **effectively**

In terms of adequacy, the internal auditor will have to review the policies of a particular department by:

- reading them
- discussion with members of the department

Then the auditor will have to assess whether the policies are adequate, and possibly advise the board of improvement.

The auditor will then have to examine the effectiveness of the controls by:

- observing them in operation
- testing them

This will be done on similar lines to the testing of controls discussed in Chapter 7. Specific examples of operational audits include the following:

Procurement	Procurement is the process of **purchasing** for the business. A procurement audit will therefore concentrate on the **systems** of the purchasing department(s). The internal auditor will be checking that the system achieves key objectives and that it operates according to company guidelines.
Marketing	Marketing is the **process of assessing and enhancing demand for the company's products**. Marketing and associated sales are very important for the business and also therefore for the internal auditor but, as the **associated systems do not directly impact on the financial statements**, they do not usually concern the external auditor. It is important for the internal auditor to review the marketing processes to ensure the following: • The process is managed efficiently. • Information is freely available to manage demand. • Risks are being managed correctly. An audit may be especially critical for a marketing department which may be complex with several different teams, for example: • research • advertising • promotions • after-sales It is vital to ensure that information is passed on properly within the department and that activities are streamlined.

Treasury	Treasury is a function within the finance department of a business. It **manages the funds** of a business so that cash is available when required. There are risks associated with treasury, in terms of interest rate risk and foreign currency risk, and the internal auditor must ensure that the **risk is managed in accordance with company procedures**. As with marketing audits, it is vital to ensure that **information is available** to the treasury department, so that they can **ensure funds are available when required**.
Human resources	The human resources department on one hand procures a human resource (employee) for the operation of the business and on the other supports those employees in developing the organisation. It is important to ensure that the processes in place ensure that people are available to work as the business requires them and that the overall development of the business is planned and controlled. Again, **ensuring company policies are maintained** and **information is freely available are key factors** for internal audit to assess.

4.5 Preparation and conducting of audits

As we have seen, the Code of Ethics and International Standards for the Professional Practice of Internal Auditing, published by the IIA, sets out the Ethics, Attributes and Standards for conducting audits. As each organisation uniquely develops its own structure for systems, controls and business processes, so too must the approach of internal auditing be considered on an organisation-specific basis. To do this, internal auditors will tend to adopt the following key steps in order to conduct and manage audits:

Business process objective	For the process being reviewed, consider what its purpose and objective is, as this will facilitate understanding the potential risk to the organisation.
Audit terms of reference	Prepare a Terms of Reference for the audit review. This will describe the area to be considered and the approach adopted. This is agreed with the business and approved by the Audit Manager.
Review current processes and controls	Before commencing testing, meet with functional management to understand actual processes, systems and controls in place. Contrast this with expected systems and controls expected to be in place.
Risks	Prepare a list of risks associated with the processes. This can be graded (possibly in terms of impact and frequency) to enable judgement in respect to testing to be performed. The risks can be mapped to the controls, to understand the purpose of the control and process.
Testing and results	Consider appropriate testing that can be conducted to provide evidence that the risk is being managed. Perform tests, agreeing conclusions with auditees. Observations to both effectiveness and efficiency of controls and processes should be considered.

Reporting	Drafting of report, providing details of process, testing, results and conclusion reached. Where issues are identified, recommendations for improvement should be provided and agreed with functional management. The report should be forwarded to both the function being reviewed and the senior management as agreed within the Terms of Reference.
Management actions and monitoring	Functional management should provide agreed actions to each recommendation, a target date and responsible person to undertake the action. Internal audit monitor and follow up the actions to ensure control deficiencies are rectified.

Professional skills focus: Assimilating and using information

If you are required to consider how an internal auditor might undertake a particular assignment, considering the various stages that each one includes is a great starting point. Logically, gaining visibility of particular aspects of an organisation helps you to understand and assess it.

5 Multi-site operations

Section overview

- The internal auditor needs to take into account a number of practical considerations when auditing multi-site operations.
- A number of approaches may be adopted including:
- compliance-based audit approach; and
- process-based audit approach.

Some organisations have several outlets which all operate the same systems. A good example of this would be a retail chain, which would have a number of shops where systems relating to inventory and cash, for example, would be the same.

The objective of audits of multi-site operations is the same as the objective of single site operations. However, as results might vary across the different locations, the internal auditor has to take a different approach. Some possible approaches to multi-site operations audits are set out below.

(a) **Compliance-based audit approach**

With a compliance-based audit approach, a master audit programme is drawn up which is used to check the compliance of the branches with the set procedures, after which the results from the branches are compared. There are two possible ways of undertaking the compliance-based approach:

(1) **Cyclical**. This approach is based on visiting all the sites within a given time frame.

(2) **Risk-based**. This alternative determines which branches are to be visited based on the risk attached to them.

(b) **Process-based audit approach**

With a process-based audit approach, the audit is planned so that specific key processes are audited. In a retail operation, for example, this could involve the important process of cash handling being audited. This approach can also be undertaken in two ways:

(1) **Cyclical**. Aims to audit all processes in a business within a set time frame.

(2) **Risk-based**. The processes to be audited are determined with reference to the risk attached to them.

5.1 Practical considerations

The practical issues to consider in relation to multi-site operations are as follows:

- Which sites to visit
- How often to visit various sites
- Whether to conduct routine or surprise visits and the mix of these types of visit

Remember that the considerations behind which sites to visit will not be the same as for external auditors. Internal auditors may consider issues (among others) such as the following:

- Size of operation
- History of systems compliance
- Quality/experience of staff on site
- Past results of testing
- Management interest in particular sites

Interactive question 3: Multi-site operations

You are the Chief Internal Auditor of Adam Ltd, which owns and operates three large department stores in Wandon, Thuringham and Tonchester. Each store has more than 22 departments.

You are at present preparing your audit plan and you are considering carrying out detailed audit tests on a rotational basis. You consider that all departments within the stores should be covered over a period of five years but that more frequent attention should be given to those where the 'audit risk' demands it.

Requirement

Describe the factors which you would consider in order to evaluate the audit risk attaching to each department.

See **Answer** at the end of this chapter.

6 Internal audit reporting

Section overview

- There are no formal reporting requirements for internal audit reports.
- This section therefore can only indicate best practice.

6.1 Objectives of reporting

The most important element of internal audit reporting is to **promote change** in the form of either **new or improved controls**. Descriptions of failings should promote change by emphasising the problems that need to be overcome and advising management on the steps needed to improve risk management strategies.

The auditors' report can emphasise the **importance of control issues** at times when other issues are being driven forward, for example new initiatives. Auditors can also help managers **assess the effect of unmitigated risk**. If auditors find that the internal control system is sound, then resources can be directed towards developing other areas.

Auditors should aim to have their **recommendations agreed by operational managers** and staff, as this should enhance the chances of their being actioned.

6.2 Forms of report

There are **no formal requirements** for internal audit reports as there are for the statutory audit. By contrast, the statutory audit report is a highly stylised document that is substantially the same for any audit. However, the following provides an indication of good practice.

The **executive summary** of an internal audit report should give the following information.

- Objectives of the assignment
- Major outcomes of the work
- Key action points
- Summary of the work left to do

The main body of the report will contain the detail; for example the audit tests carried out and their findings, full lists of action points, including details of who has responsibility for carrying them out, the future timescale and costs.

One clear way of presenting observations and findings in individual areas is as follows:

- Business objective that the manager is aiming to achieve
- Operational standard
- The risks of current practice
- Control weaknesses or lack of application of controls
- The causes of the weaknesses
- The effect of the weaknesses
- Recommendations to solve the weaknesses

The results of individual areas can be summarised in the main report:

- The existing culture of control, drawing attention to whether there is a lack of appreciation of the need for controls or good controls but a lack of ability to ensure compliance
- Overall opinion on managers' willingness to address risks and improve
- Implications of outstanding risks
- Results of control evaluations
- The causes of basic problems, including links between the problems in various areas

When drafting recommendations internal audit needs to consider the following:

- The available options, although the auditors' preferred solution needs to be emphasised
- The removal of obstacles to control. It may be most important to remove general obstacles such as poor communication or lack of management willingness to enforce controls before making specific recommendations to improve controls

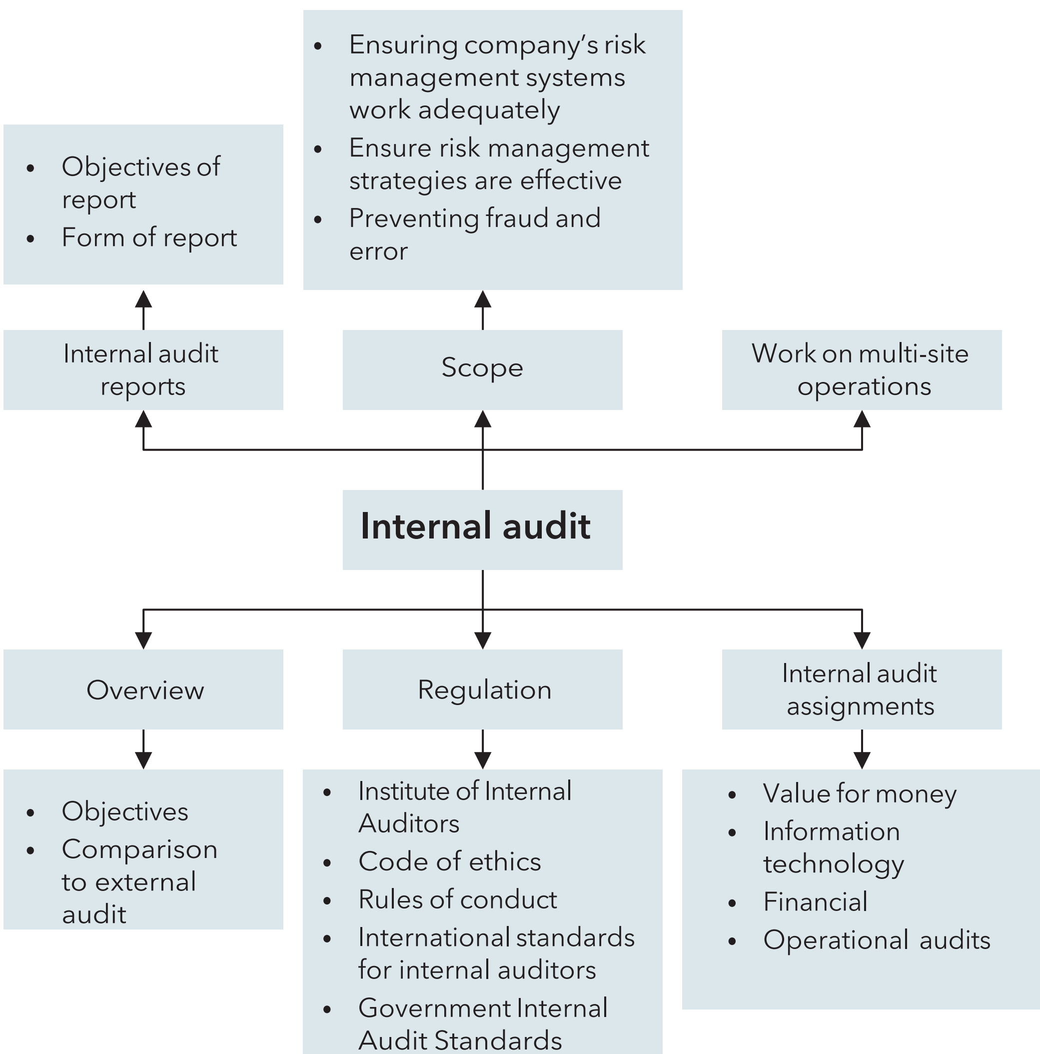
- Resource issues, how much will recommendations actually cost and also the costs of poor control

Recommendations should be linked in with the terms of reference, the audit performed and the results.

Professional skills focus: Concluding, recommending and communicating

You have already practised explaining how the external auditor concludes and recommends as part of addressing deficiencies in internal control. Now you need to be able to express similar conclusions from the perspective of the internal auditor. The key theme here is how you can get the message across, regardless of the circumstances.

Summary



1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Can you remember what the internal audit function does and how it differs from external audit?
2.	Can you explain the various codes and standards in place to regulate internal auditors?
3.	Internal auditors can assist in sound governance practices by supporting risk management and combatting fraud and error. True or false?
4.	Can you list the various assignments that an internal audit function might get involved in and explain how each one would be undertaken?
5.	Are you able to explain the impact on an internal audit function if the organisation operates across several sites?
6.	Would you know how to communicate your findings if you were employed as an internal auditor?

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Blackfoot Emissions Ltd	This question puts you in the position of Internal Audit manager and requires a series of practical solutions regarding how the internal audit function might address issues such as setting up an audit charter and planning a payroll audit.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios that will help you improve your knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Jupiter	This question demonstrates how the external auditor might be required to evaluate the impact of internal audit on their work and how much (if any) reliance can be placed upon it.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries.

You have now come to the end of this stage of your studies.

1 Attribute standards (AS)

- Purpose, authority and responsibility – **AS 1000**
- Independence and objectivity – **AS 1100**

- Proficiency and due professional care – **AS 1200**
- Quality assurance and improvement programme – **AS 1300**

2 **Performance standards (PS)**

- Managing the internal audit activity – **PS 2000**
- Nature of work – **PS 2100**
- Engagement planning – **PS 2200**
- Performing the engagement – **PS 2300**
- Communicating results – **PS 2400**
- Monitoring progress – **PS 2500**

Self-test questions

- Communicating the acceptance of risks – **PS 2600**

Answer the following questions

1 Internal auditing

Blackfoot Emissions Ltd has grown exponentially in recent years providing emissions monitoring and environmental management services to clients within the UK. All the management systems are centralised at the head office, although there exist five regional offices across the country in order to provide local response to clients' requirements. These local offices all use the corporate systems on a networked basis.

The board of directors have agreed that it is appropriate to establish an Internal Audit Function and you have been appointed as the Internal Audit Manager.

Requirements

1.1 You have been requested to recommend to the board how the function will operate. Prepare an Audit Charter.

1.2 The Finance Director has called you into his office and expressed concerns over the management of the payroll system, particularly now that the company has grown and is employing many consultants.

The Payroll department is incorporated within the Human Resources department and uses a software package called Upay. A single person has full responsibility for its operation and administers the whole process. Prepare a draft of the business process objective, and identify the key risks and appropriate controls that you would expect to find that require testing.

1.3 Draft the Terms of Reference for the Payroll Audit in preparation for circulation to senior management.

Answers to Interactive questions

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answer to Interactive question 1

The internal auditors review and test the system of internal control and report to management in order to improve the information received by managers and to help in their task of running the company. The internal auditors will recommend changes to the system to make sure that management receive objective information that is efficiently produced. The internal auditors will also have a duty to search for and discover fraud.

In most jurisdictions, the external auditors review the system of internal control in order to determine the extent of the substantive work required on the year-end accounts. The external auditors report to the shareholders rather than the managers or directors. It is usual, however, for the external auditors to issue a letter of weakness to the managers, laying out any control deficiencies and recommendations for improvement in the system of internal control. The external auditors report on the truth and fairness of the financial statements, not directly on the system of internal control. The external auditors do not have a specific duty to detect fraud, although they should plan the audit procedures so as to have reasonable assurance that they will detect any material misstatement in the accounts on which they give an opinion.

Answer to Interactive question 2

(a) **Board of directors**

A high level of independence is achieved by the internal auditors if they report directly to the board. There may be problems with this approach.

(1) The members of the board may not understand all the implications of the internal audit reports when accounting or technical information is required.

(2) The board may not have enough time to spend considering the reports in sufficient depth. Important recommendations might therefore remain unimplemented.

A way around these problems might be to delegate the review of internal audit reports to an audit committee, which would act as a kind of subcommittee to the main board. The audit committee might be made up largely of non-executive directors who have more time and independence from the day to day running of the company.

(b) **Chief accountant**

It would be inappropriate for internal audit to report to the chief accountant, who is in charge of running the system of internal control. It may be feasible for them to receive the report as well as the board. Otherwise, the internal audit function cannot be effectively independent, as the chief accountant could suppress unfavourable reports or could just not act on the recommendations of such reports

Answer to Interactive question 3

Risk may be evaluated by considering:

- the probability of an event
- the potential size of the event

In the case of an audit the event concerned is undetected material error or fraud.

In evaluating risk in the context of the audit of a company owning and operating three large department stores, the factors to be considered are as follows.

Factors influencing probability

(1) Strengths and deficiencies in the system of internal control, overall and for each individual store and department in respect of all types of internal control. It would be appropriate to consider such controls under the following headings.

  - Organisation of staff
  - Segregation of staf
  - Physical controls
  - Authorisation and approval
  - Arithmetic and accounting
  - Personnel
  - Supervision
  - Management

(2) Experience derived from previous audits and the conclusion of previous audit reports

(3) Whether the prices of goods sold are fixed by head office or variable by local store or departmental managers

(4) Extent of local purchasing for each store or department

(5) The nature of the inventory (for example high unit value, attractiveness)

(6) Effectiveness of cash-handling systems

Factors influencing size

(1) Relative size of department in terms of:
  - revenue
  - number of transactions
  - average value of inventory

(2) Internal statistics of losses through shoplifting and staff theft

Other general factors

(1) Comparison among stores and among like departments in the three stores, using ratio analysis

(2) Risk of deterioration or obsolescence of inventories

(3) Rate of turnover of store staff

Answers to Self-test questions

1 Internal auditing

1.1 Internal audit charter Purpose

Internal Audit is an independent review function set up within the organisation to provide assurance to the board on the adequacy and effectiveness of business systems and controls.

Independence

Internal Audit maintains an independent stance from the activities which it audits to ensure the unbiased judgements essential to its proper conduct and impartial advice to management.

Role and scope

The main role of Internal Audit is to help management with providing assurance as to the adequacy and efficiency of its business systems and controls. It does this by understanding the key risks of the organisation and by examining and evaluating the adequacy and effectiveness of the system of risk management and internal control as operated by the organisation.

Internal Audit, therefore, has unrestricted access to all activities and information undertaken in the organisation, in order to review, appraise and report on the following:

- The adequacy and effectiveness of the systems of internal control. These shall include both financial and operational systems.
- The suitability, accuracy, reliability and integrity of financial and other management information and the systems used to generate such information.
- The extent of compliance with rules and standards established by management, and with externally set laws and regulations.
- The efficient acquisition and use of assets, ensuring that they are accounted for and safeguarded from losses of all kinds arising from waste, extravagance, inefficient administration, poor value for money, fraud or other cause and that adequate business continuity plans exist.
- The integrity of processes and systems, including those under development, to ensure that controls offer adequate protection against error, fraud and loss of all kinds; and that the process aligns with the organisation's strategic goals.
- The effectiveness of the function being audited, and to ensure that services are provided in a way which is economical and efficient.
- The follow-up action taken to remedy deficiencies identified by Internal Audit review, ensuring that good practice is identified and communicated widely.
- The operation of the organisation's corporate governance arrangements.

The board shall monitor the performance of the Internal Audit Function and the Head of Internal Audit shall report annually on the function's performance.

Reporting

Internal Audit reports regularly on the results of its work to the Audit Committee, which is a Board subcommittee. The Head of Internal Audit is accountable to the Audit Committee for the following:

- Providing regular assessments of the adequacy and effectiveness of the organisation's systems of risk management and internal control based on the work of Internal Audit.
- Reporting significant control issues and potential for improving risk management and control processes.
- Periodically providing information on the status and results of the annual audit plan and the sufficiency of Internal Audit resources.

Responsibility

The Head of Internal Audit reporting to the Managing Director and Audit Committee is responsible for effective review of all aspects of risk management and control throughout the organisation's activities.

The Head of Internal Audit is responsible for the following:

- Developing an annual audit plan based on an understanding of the significant risks to which the organisation is exposed; and agreeing it with the Audit Committee
- Implementing the agreed audit plan
- Maintaining a professional audit staff with sufficient knowledge, skills and experience to carry out the plan

1.2 Business objective for Human Resources payroll function

To provide accurate, agreed and timely payment to staff, in compliance with legislative and tax requirements, while providing effective, reliable, secure and maintainable records.

Key risks and controls

Category	Risk	Control
Reliability and integrity of financial and operational management	Creation of ghost employees	Segregation of data input and activation of payroll accounts within the system.
		Limited and controlled access to the system (eg, user logins and passwords).
		Creation or changes can only be entered on receipt of authorised change forms.
	Accuracy of data input	Each employee must have an individual payroll number and personnel file containing details of employment.
		Verification of data changes within the system by a separate person.
		Information relating to new starters is authorised and passed to payroll for input.

Category	Risk	Control
		Advances, loans and additional payments are supported by managerial authorisation, and separately identified within the system.
	Timely input of information	Regular system report to detail changes for comparison to employee files.
		Leavers are promptly removed or suspended within the system, as accepted within the agreed notice period.
		Payroll verifies to the business that input has occurred.
	Accuracy of payment data	Payment report generated and reviewed in advance of payment date.
		Payment run report and exception report are generated detailing data changes from previous period. This is authorised by an independent person before transfer of payments.
		Overtime payments are based on authorised timesheets.
	Inaccurate financial reporting	Payment report reconciled to bank statement and general ledger by independent person.
	Insecure and unreliable IT systems	Access to IT systems and network is limited to authorised personnel only.
	Payroll system Upay access is restricted by user login and secure password restrictions.	
	Adequate back-up and recovery processes are established and tested on a regular basis.	
	Insecure personnel files	Personnel files are held securely, with restricted access.

Category	Risk	Control
		Personnel information management systems are registered with the Information Commissioner's Office.
Effectiveness and efficiency of operation	Payroll department inadequately resourced	Payroll department has been established with clearly defined objectives and adequate resources.
	Potential for inconsistent processes and practices	Policies and procedures are in place to give guidance on the use and control of the system and business processes.
	Amendments to IT systems and processes are conducted in a controlled and authorised manner.	
Safeguarding of assets	Aggravation of staff	Ensure efficient operation of process within the key controls identified.
Compliance with legislation, codes and law	Inexperienced payroll staff	Payroll personnel are suitably experienced and qualified. They have information feeds that keep them abreast of changes to legislation and requirements.
	Tax Office communications are not passed to the Payroll function	Changes to tax codes are only actioned on receipt of formal notification from HMRC.
	Inability to produce legally required reports	Procedures exist for the generation of legally required documents such as P60, P45 and P11D.
	Reports generated late	Diary system operated to ensure that payment of all tax liabilities meets the requirements of statutory authority.
	Inaccurate or late payment of tax and National Insurance	Tax and National Insurance are collected by the system, reconciled on a monthly basis and paid over in accordance with Revenue guidelines and timescales.

Category	Risk	Control
	Data is not secure in compliance with Data Protection Act requirements	Payroll system access is restricted, and users have agreed to operate within an agreed 'Code of Conduct'. Information and reports generated are issued on controlled circulation listing.

1.3 **Draft terms of reference Subject** Payroll

Managers responsible Head of HR Payroll Manager

Audit scope

The audit will review the adequacy of controls and processes in existence over the administration and management of the payroll system. In particular the audit will review the following factors:

- System security arrangements for both IT and paper information
- Data security arrangements and compliance with the Data Protection Act
- Controls over the timely creation of new employees
- Amendment of data within the system
- Monthly reporting and reconciliation processes
- Segregation and approvals
- Conformance with statutory requirements

Management reporting

Any issues identified by the review will be discussed at the close out meeting and raised with the appropriate manager, and a draft report prepared. The draft report will be issued to relevant staff for comment and responses to recommendations. The final report will be circulated to the distribution list below.

Target dates for issue of the reports are:

- issue of draft report within seven days of the audit; and
- the business to agree a final report within 21 days of the draft report being issued.

Audit report distribution

The final report will be addressed to the Managing Director. Copies shall be issued to:

- Finance Director
- Operations Director
- Technical Director
- Head of Human Resources

Resources and timescales

Auditors: Doug Deeper

Timescale: Fieldwork commencing 1 July 20X8, for 2 weeks

Chapter 28

Accounting and Reporting Standards and Practices

Introduction

Topic List

Learning outcomes

It is expected that after completing the chapter students will be able -

- Specify the accounting standards for the public sector
- Narrate the framework of public sector accounting standards
- Narrate the cash basis accounting standards in the public sector
- Explain the International Public Sector Accounting Standards
- Explain the transformation of cash basis accounting to accrual basis accounting
- Explain the requirements of Integrated Financial Management Information Systems
- Explain the accounting systems in the public sector of Bangladesh

Syllabus Links

The material in this chapter is linked to the previous course in the Certificate Level module of Accounting.

Examination Context

Questions on topics in this chapter will be descriptive and mathematical. In the exam you may be required to:

- Identify the public sector accounting practices.
- Apply the concept of cash basis accounting
- Demonstrate the implementation of International Public Sector Accounting Standards (IPSAS)
- Demonstrate the implementation of accrual basis accounting in the public sector.
- Identify the use of Integrated Financial Management Information Systems (IFMIS)
- Highlight the practice of accounting in Bangladesh.

Introduction

This chapter is linked with the previous course – Accounting of certificate level. The aim of this chapter of this workbook is to introduce the public sector accounting practices. The practices of accounting in the public sector are different than the private sector. The practices are diverse (regarding the countries and level of governments) across the world as well. This chapter focuses on the accounting practices of central/general government. Therefore, public sector accounting and government accounting are interchangeable in this chapter. The chapter focuses on two broad issues – 1) Cash Basis accounting and 2) Unique International Public sector accounting Standard (IPSAS).

Though cash basis is not the appropriate method, many countries are following the cash basis accounting. Considering the situation this chapter has highlighted the cash basis IPSAS, on which details has been mentioned in this chapter. As this workbook has focused on the IFRS already, this chapter brought the light on the unique IPSAS only. Though there are several unique IPSAS (not many), this chapter focuses on unique IPSASs – IPSAS 22 (Disclosure of Financial Information about the General Government Sector), 23 (Revenue from Non-Exchange Transactions (Taxes and Transfers)) and 24 (Presentation of Budget Information in Financial Statements).

1.1 Public Sector Accounting Standards and Policies

Beginning in the mid-1990s, government accounting – in terms of substantive provisions and institutional arrangements – exemplified by Australia and New Zealand was promoted at the international level. Building on a decade-long research effort, the Public Sector Committee (PSC) of the International Federation of Accountants (IFAC) initiated a program to develop and disseminate international public sector accounting standards (IPSAS). The program has received endorsement and financial support from several international financial and development institutions interested in advancing the cause of better financial management and greater accountability. At the conclusion of the first phase of the program in 2002, the PSC promulgated 20 standards by adapting international accounting standards for business enterprises, later renamed international financial reporting standards, or IFRS.

During the second phase, ongoing since 2002, the PSC and its successor, the IPSAS Board, have produced six standards on issues unique to the public sector while continuing to adapt IFRS in other standards. The board also produced one cash-basis standard for governments unready to adopt the accrual-basis IPSAS. Since 2008, the board started a five-year conceptual framework project (IPSAS Board 2011c) to provide theoretical underpinnings for its work.

1.1.1 IPSAS and Corresponding IFRS

Most of the IPSASs are equivalent to IAS/IFRS. As this workbook has highlighted the IFRS in details, a list of IPSAS and corresponding IFRS will be very helpful. To understand properly, anyone can check the final section of each IPSAS where the difference between the IPSAS and corresponding IFRS/IAS has been mentioned.

IPSAS	Title	Corresponding IFRS
IPSAS 1	Presentation of Financial Statements	IAS 1
IPSAS 2	Cash Flow Statements	IAS 7
IPSAS 3	Accounting Policies, Changes in Accounting Estimates and Errors	IAS 8
IPSAS 4	The Effects of Changes in Foreign Exchange Rates	IAS 21
IPSAS 5	Borrowing Costs	IAS 23
IPSAS 6	Consolidated and Separate Financial Statements	IAS 27
IPSAS 7	Investments in Associates	IAS 28
IPSAS 8	Interests in Joint Ventures	IAS 31
IPSAS 9	Revenue from Exchange Transactions	IAS 18
IPSAS 10	Financial Reporting in Hyperinflationary Economies	IAS 29
IPSAS 11	Construction Contracts	IAS 11
IPSAS 12	Inventories	IAS 2
IPSAS 13	Leases	IAS 17
IPSAS 14	Events After the Reporting Date	IAS 10
IPSAS 15	Financial Instruments: Disclosure and Presentation	IAS 32
IPSAS 16	Investment Property	IAS 40
IPSAS 17	Property, Plant and Equipment	IAS 16
IPSAS 18	Segment Reporting	IAS 14
IPSAS 19	Provisions, Contingent Liabilities and Contingent Assets	IAS 37
IPSAS 20	Related Party Disclosures	IAS 24
IPSAS 21	Impairment of Non-Cash-Generating Assets	IAS 36
IPSAS 22	Disclosure of Financial Information about the General Government Sector	No corresponding IFRS
IPSAS 23	Revenue from Non-Exchange Transactions (Taxes and Transfers)	No corresponding IFRS
IPSAS 24	Presentation of Budget Information in Financial Statements	No corresponding IFRS
IPSAS 25	Employee Benefits	IAS 19
IPSAS 26	Impairment of Cash-Generating Assets	IAS 36
IPSAS 27	Agriculture	IAS 41
IPSAS 28	Financial Instruments: Presentation	IAS 32/IFRIC 2
IPSAS 29	Financial Instruments: Recognition and Measurement	IAS 39/IFRIC 9/ IFRIC 16
IPSAS 30	Financial Instruments: Disclosures	IFRS 7

IPSAS	Title	Corresponding IFRS
IPSAS 31	Intangible Assets	IAS 38/SIC 32
IPSAS 32	Presentation of Financial Statements	Mirror to SIC 12
IPSAS 33	First-time Adoption of Accrual Basis IPSASs	IFRS 1
IPSAS 34	Separate Financial Statements	IAS 27
IPSAS 35	Consolidated Financial Statements	IFRS 10
IPSAS 36	Investments in Associates and Joint Ventures	IAS 28
IPSAS 37	Joint Arrangements	IFRS 11
IPSAS 38	Disclosure of Interests in Other Entities	IFRS 12
IPSAS 39	Employee Benefits	IAS 19
IPSAS 40	Public Sector Combinations	N/A
IPSAS 41	Financial Instruments	IFRS 9
Cash Basis IPSAS	Cash Flow Statements	No corresponding IFRS

Two basic IPSAS has been discussed in this workbook.

1) Cash Basis IPSAS and

2) Accrual Basis IPSAS: IPSAS 22, 23 and 24

1.2 IPSAS: Financial Reporting Under the Cash Basis of Accounting

This workbook focuses on the Cash Basis IPSAS Financial Reporting Under the Cash Basis of Accounting (cash basis IPSAS has been referred as 'the standard' in the remainder of this study unit for the sake of brevity).

The purpose of this standard is to prescribe how financial statements should be presented under the cash basis of accounting.

The adoption of IPSAS by governments will improve both the quality and comparability of financial information reported by public sector entities around the world. The IPSASB recognizes the right of governments and national standard-setters to establish accounting standards and guidelines for financial reporting in their jurisdictions. The IPSASB considers that this Standard is an important step forward in improving the consistency and comparability of financial reporting under the cash basis of accounting and encourages the adoption of this Standard. **Financial statements should be described as complying with this IPSAS only if they comply with all the requirements of Part 1 of this IPSAS.**

The IPSASB encourages governments to progress to the accrual basis of accounting and to harmonize national requirements with the IPSAS prepared for application by entities adopting the accrual basis of accounting.

Cash basis IPSAS gives users of the accounts an understanding of the timing and certainty of cash receipts and cash payments so that they can make economic decisions.

The standard comprises two parts:

- Part 1 is mandatory if an entity is using the cash basis of accounting. This part of the standard contains key definitions relating to the cash basis, establishes the presentation and disclosure requirements and deals with specific accounting issues;
- Part 2 is not mandatory. It identifies additional accounting policies and disclosures that an entity is encouraged to adopt to enhance accountability and transparency of its financial statements. It also explains alternative methods of presentation.

The standard applies to all public sector entities other than Government Business Enterprises (which are profit-oriented and therefore comply with IFRSs and IASs). **In this workbook, we will look at Part 1 of the Standard only.**

Part 1 of the standard: Introduction

1.2.1 Key Definition

Before we consider how information is presented and disclosed under the cash basis of accounting we need to learn some key definitions from the Standard.

Key definitions:

Cash

Cash comprises of cash on hand, demand deposits and cash equivalents.

Cash flows

Cash flows are inflows (cash receipts) and outflows (cash payments) of cash.

Cash equivalents

Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to insignificant risk of changes in value.

Cash basis

Cash basis means a basis of accounting that recognises transactions and other events only when cash (including cash equivalents) is received or paid.

Financial statements prepared under the cash basis show the sources of cash raised during the period, the purposes for which cash was used and the cash balances at the reporting date. The measurement focus is balances of cash and changes in those balances, although notes to the financial statements may provide additional information about liabilities (for example payables, borrowings) and non-cash assets (for example receivables, investments, property).

Control of cash

Cash is controlled by an entity when the entity can use the cash for the achievement of its own objectives or otherwise benefit from the cash and exclude or regulate the access of others to that benefit.

Control of cash

The definition of control of cash is of key importance to your understanding of the Cash Basis IPSAS as it determines the way in which cash transactions are treated in the statements prepared under the Cash Basis IPSAS.

Cash collected by, or appropriated or granted to, an entity which the entity can use to fund its operating objectives, acquire capital assets or repay its debt is controlled by the entity.

Amounts deposited in the bank account of an entity are controlled by that entity. For example, cash collected by an entity on behalf of its government is deposited in its own bank account before being transferred to the government's account.

Another example is where cash transferred by an entity to third parties on behalf of its government is initially deposited with the entity prior to transfer to the recipient.

In both examples, the cash is controlled by the entity only for the period during which the cash is held in its bank account prior to transfer to the government or to a third party. Any cash balances held by an entity at reporting date that are not available for use by the entity or are subject to external restrictions should be disclosed.

Interactive Question 1.1 (Control of Cash)

Requirement

Which of the following scenarios describes "control of cash" as belonging to the state government under the Cash Basis IPSAS?

(a) The state government had a hospital built on its behalf by an international charity. All payments were made directly by the international charity to the building contractors.

(b) A state government collects taxes on behalf of both itself and the federal government. The taxes relating to the federal government are held the state government's bank account at the reporting date, but the cash will be transferred to the federal government shortly after the reporting date.

See **Answer** at the end of this chapter.

Treasury Single Account

The term Treasury Single Account is required to understand from the IPSAS.

Any cash held by spending agencies in the banking system overnight represents an opportunity cost and, from the treasury's perspective, a loss of visibility and control. The solution has been to aggregate all government cash balances in an account or set of linked accounts – termed the treasury single account (TSA). The TSA is a unified structure of government bank accounts that gives a consolidated view of government cash resources. This one is called single account basis also. A single account basis is where a government manages the expenditure of its individual departments through a centralised treasury function so that individual departments and entities do not control their own bank accounts. The central entity makes payments on behalf of individual departments and entities after appropriate authorisation and documentation. Consequently, individual departments and entities do not control the cash that they have been authorised to spend. In these cases, expenditures made by individual departments and entities will be reported in a separate column headed "treasury account" in the statement of cash receipts and payments.

1.2.2 Presentation and disclosure requirements in part 1 of the standard

We will now consider the statements that are required to be prepared and the disclosure requirements under Part 1 of the standard.

The financial statements should include the following components:

- **A statement of cash receipts and payments.** This statement should recognise all cash receipts, cash payments and cash balances controlled by the entity. It should separately identify payments made by third parties on behalf of the entity;

- **Accounting policies and explanatory notes.** These will include narrative descriptions, detailed schedules, analyses of amounts shown on the face of the statements and other disclosures necessary to achieve a fair presentation and enhance accountability. Any information prepared on a different basis from the cash basis should be disclosed in the notes to the financial statements;
- **A comparison of budget to actual amounts.** When an entity makes publicly available its approved budget, a comparison of budget and actual amounts should be prepared. This may be a separate additional financial statement, or if prepared on a comparable basis, a column may be included in the statement of cash receipts and payments.

Additional statements may also be prepared which show, for example;

- cash receipts, cash payments and cash balances for major fund categories;
- sources and deployment of borrowings.

Entities that report using the cash basis of accounting may also collect information on items that are not recognised under a cash basis of accounting. For example:

- receivables, payables, borrowings and other liabilities, non-cash assets, accruals;
- commitments and contingent liabilities;
- performance indicators and the achievement of service delivery objectives.

Such information may be disclosed in the notes to the financial statements where it is likely to be useful to users. Where such disclosures are made they should be clearly described and readily understandable.

1.2.3 The statement of cash receipts and payments

In this section, we will focus on the content of the statement of cash receipts and payments. The statement should include:

- Total cash receipts of the entity. This should be sub-classified into separate items which reflect the entity's operations;
- Total cash payments of the entity. This should also be sub-classified into separate items which reflect the entity's operations;
- Beginning and closing cash balances of the entity.

1.2.3.1 Gross or net basis?

It is normal practice to report accounting transactions on a gross basis. This principle also applies to cash receipts and payments but there are some instances where reporting on a net basis is allowed.

Governments, government departments and other government entities may administer transactions or act as agents on behalf of others. These administered and agency transactions may include the collection of revenues on behalf of another entity, the transfer of funds to eligible beneficiaries or the safekeeping of monies on behalf of constituents.

Examples of such activities may include:

- The collection of taxes by one level of government for another level of government;
- The acceptance and repayment of demand deposits of a financial institution;
- Funds held for customers by an investment or trust entity;
- Rents collected on behalf of, and paid over to, the owners of properties;

- Transfers by a government department to third parties consistent with legislation or other government authority; and
- Funds administered by a central entity under the "single account" basis for management of government expenditure.

In some cases, the amounts of the cash flows arising from administered transactions which "pass through" the bank account of the reporting entity may be large relative to the entity's own transactions, and control may occur for only a short time before the amounts are transferred to the ultimate recipients. This may also be true for other cash flows including for example, advances made for, and the repayment of:

- The purchase and sale of investments; and
- Other short-term borrowings, for example, those which have a maturity period of three months or less.

If these transactions are recorded on a gross basis this may result in a distorted picture of the entity's cash flows and therefore reduce the usefulness of the statement. The standard therefore permits cash receipts and cash payments to be reported on a net basis in the statement if they:

- Arise from transactions which the entity administers on behalf of other parties and which are recognised in the statement of cash receipts and payments, or,
- Are for items in which the turnover is quick, the amounts are large, and the maturities are short.

Interactive Question 1.2 Reporting cash flows on a net basis

Requirements

Indicate whether the hospital's statement of cash receipts and payments should present each of the two cash receipts and payments on a gross or net basis:

(i) Cash outflow of BDT150,000 in full settlement of a negligence claim by a patient. Ten months after this date, following a long legal battle, the hospital received BDT150,000 in insurance money from the insurers of the doctor involved in the negligent care.

(ii) Cash inflows totalling BDT320,000 in relation to payments collected on behalf of the central government's Department of Health from customers for prescription drug charges. The full amount collected is paid over to the Department of Health at the end of each week, as required by the hospital's charter.

See **Answer** at the end of this chapter.

1.2.3.2 Format of the statement of cash receipts and payments

Users should be able to easily access and understand the format of the cash receipts and payments statement. To give thorough information and an equitable presentation, line items, headings, and subtotals must be provided.

It should be noted that the cash flow statement as per IPSAS 2 is different than the cash-based IPSAS. IPSAS 2 requires the presentation of information about the historical changes in cash and cash equivalents of an entity by means of a cash flow statement which classifies cash flows during the period by operating, investing and financing activities.

Sub classification of total receipts and payments

The standard does not prescribe sub classifications of total cash receipts and payments as this is a matter of professional judgement, based on the situation of the entity. Payments may be split by nature (for example staff costs, rent) or function (for example education, healthcare).

> **Interactive Question 1.3 Sub classifications in the statement of cash receipts and Payments**
>
> **Requirement**
>
> List the subcategories of total cash receipts and payments that would appear on the face of the statement of cash receipts and payments, using a public sector organization that you are familiar with as an example.
>
> See **Answer** at the end of this chapter.

The sub classifications of total cash receipts and payments are a matter of professional judgement but should be presented in the context of the qualitative characteristics of financial reporting under the cash basis of accounting. The qualitative characteristics are:

- Understandability;
- Relevance;
- Reliability;
- Comparability.

Payments by third parties on behalf of the entity

Sometimes, a third party may make a payment on behalf of an entity or purchase goods and services which benefit the entity. For example, a national government may fund the operation of a health or education project for an independent municipal government by directly paying service providers and acquiring and transferring to the municipal government the necessary supplies.

> **Key definition: Third party payments**
>
> A third party payment is when a third party directly settles the obligations of an entity of purchases goods and services for the benefit of the entity.

When this happens, these transactions should be shown in a separate column on the face of the statement of cash receipts and payments. It also needs to be shown whether the third party is an internal or external third party. An internal third party would belong to the same overall reporting group as the entity.

These third party transactions would need to be formally verified before they are included in the statement, because of the fact that they are made directly without cash ever appearing on the entity's bank statement.

> **Interactive Question 1.4 Third party transactions**
>
> **Requirement**
>
> Describe how the cash receipts and payments statement for each of the following entities will display the third-party transactions:
>
> (a) An individual government department has its expenditure managed through a centralised treasury function (single account) and payments are made by the

government on behalf of the department after appropriate authorisation and documentation is received by the treasury.

(b) An individual government department with its own bank account who has certain goods purchased on its behalf by another government department.

(c) (c) The government of a country who has had a new motorway system constructed by an international development agency during the year. All payments were made directly by the agency to the building contractors.

See **Answer** at the end of this chapter.

1.2.3.3 Preparing the statement of cash receipts and payments

The format of the statement is shown in this blank pro forma. You may find it useful to print several copies of this and use it when practising the exercises that appear later in this workbook.

Statement of cash receipts and payments

	Receipts/ payments controlled by the entity	**Payments by third parties**
Receipts		
Total receipts		
Payments		
Total payments		
Increase / (decrease) in cash		
Cash at beginning of year		
Cash at end of year		

Worked example: Preparing the statement of cash receipts and payments (Department of Agriculture)

The Department of Agriculture (A central government agency), uses the Cash Basis IPSAS to generate its financial statements. Its records of cash receipts and payments for the year ended 31 December 20X0 are summarised as follows:

Receipts	BDT'000	Payments	BDT'000
Funding allocations	47,592	Wages, salaries and employee benefits	46,760
Proceeds from borrowing	8,392	Supplies and consumables	1,829
Receipts from trading activities	2,100	Rent	568

Receipts	BDT'000	Payments	BDT'000
Proceeds from disposal of property, plant and equipment	587	Purchase of property, plant and equipment	7,800
Interest received	22	Repayment of borrowings	39
		Interest payments	67
Total receipts	**58,693**	**Total payments**	**57,063**

Additional information:

- The cash balance at the start of the year was BDT65,000.
- Several of the department's directors share their time 50:50 with the Department of Transport. Their salaries, which total BDT1.5m, are paid directly to the directors by the Department of Transport. The two departments are in the same overall reporting entity.
- The cash records were reconciled to the bank statement as at 31 December 20X0 and the following issues were discovered:
  1) An interest payment of BDT35,000 was deducted by the bank from the government's bank account on 30 December 20X0. This has not yet been accounted for in the department's cash records.
  2) A bank transfer of BDT58,000 was received into the department's bank statement on 29 December in relation to trading activities, but has not yet been accounted for in the department's cash records.
  3) BDT300,000 of the total amount shown as proceeds from disposal of property, plant and equipment was not in fact received during the year. The purchaser of the equipment was sent an invoice for BDT300,000 on 31 December 20X0, which was then paid on 18 January 20XI.

Requirement

Prepare the department's statement of cash receipts and payments for the year-ended 31 December 20X0. Note that prior year comparatives are not required.

Solution to worked example

The summarised cash information that was given in the question needs to be presented in accordance with the IPSAS. The first step is to set out a blank pro forma of all the headings that will be needed, based on the requirements of the IPSAS and the line items that you know will be needed based on the information given in the question.

Note that in this example, we are classifying payments by nature for example wages and salaries, payments to acquire property plant and equipment etc). The alternative method is to categorise payments by function (for example Crops and horticulture, Animal health and welfare etc), but we have not been given the information needed in the question to be able to analyse payments by function.

Note also that the payment of salaries to the directors is a payment by a third party (i.e. the Department of Transport) and we will need an additional column to reflect this.

The pro forma will therefore look like below. Note that a real published version would include further columns with comparative figures for the previous financial year, but we have only been asked to prepare the current year figures.

Department of Agriculture

Statement of cash receipts and payments for year ended 31 December 20X0

	Receipts/ payments controlled by the entity	Payments by third parties
Receipts		
Funding allocations		
Proceeds from borrowing		
Receipts from trading activities		
Proceeds from disposal of property, plant and equipment		
Interest received		
Total receipts		
Payments		
Wages, salaries and employee benefits		
Supplies and consumables		
Rent		
Purchase of property, plant and equipment		
Repayment of borrowings		
Interest payments		
Total payments		
Increase / (decrease) in cash		
Cash at beginning of year		
Cash at end of year		

We can now slot in the numbers given to us in the question. Note that adjustments will need to be made for the items noted during the reconciliation of the cash records to the bank statement as follows:

1) Interest payment of BDT35,000 to be added to interest payments in the payments section.
2) Bank transfer of BDT58,000 to be added receipts from trading activities in the receipts section.
3) BDT300,000 to be deducted from proceeds of disposal of property, plant and equipment within the receipts section, as the cash was not received during the year. The amount owed by the purchaser is a receivable, and under the cash basis method of financial reporting this would not appear in the main statements, although the organisation may separately present information on receivables in the notes to the statements.

We will also need to include 50% of the BDT1.5m directors' salaries (i.e. BDT750,000) within the payments by third parties column to reflect that this cost was incurred by the department in the year but paid out of cash not controlled by the department. The BDT750,000 also represents a source of income to the department, albeit one where the cash is not controlled, and hence it is shown within funding allocations in the payments by third parties column. As the Department of Transport is in the same overall reporting group as the Department of Agriculture, we need to clarify that this is an internal third party.

Department of Agriculture

Statement of cash receipts and payments for year ended 31 December 20X0

	Receipts/ payments controlled by the entity	Payments by third parties
	BDT'000	BDT'000
Receipts		750
Funding allocations	47,592	
Proceeds from borrowing	8,392	
Receipts from trading activities (2,100 + 58)	2,158	
Proceeds from disposal of property, plant and equipment (587 - 300)	287	
Interest received	22	
Total receipts	58,451	750
Payments		
Wages, salaries and employee benefits	(46760)	(750)
Supplies and consumables	(1829)	
Rent	(568)	
Purchase of property, plant and equipment	(7800)	
Repayment of borrowings	(39)	
Interest payments (67 + 35)	(102)	
Total payments	**(57098)**	**(750)**
Increase / (decrease) in cash	**1,353**	
Cash at beginning of year	65	
Cash at end of year	**1,418**	

Interactive Question 1.5 Statement of cash receipts and payments (St Mary Hospital)

St Mary Hospital prepares its financial statements in accordance with the Cash Basis IPSAS. Its records of cash receipts and payments for the year ended 31 March 20X0 are summarised as follows:

Receipts	**BDT'000**	**Payments**	**BDT'000**
Funding allocations	9,560	Wages, salaries and employee benefits	10,289
Proceeds from borrowing	1,234	Medicines, supplies and consumables	576
Private patient and other income	1,958	Utilities	93
Proceeds from disposal of property, plant and equipment	35	Purchase of property, plant and equipment	1,829
Interest received	8	Repayment of borrowings	98
		Interest payments	80
Total receipts	**12,795**	**Total payments**	**12,965**

Additional information:

- The opening cash balance was BDT185,000.
- A piece of surplus medical equipment was sold for BDT210,000 cash on the last day of the financial year, but this was not included in the amounts shown above.
- The Department of Health purchases most medicines centrally on behalf of all of the country's hospitals. The total amount paid by the Department of Health in relation to medicines for St Mary Hospital during the year was BDT1.3m. The Department of Health is part of the same overall reporting entity as St Mary Hospital.

Requirement

Prepare the statement of cash receipts and payments for St Mary Hospital for the year-ended 31 March 20X0. Comparatives for the previous year are not required.

See **Answer** at the end of this chapter.

1.2.4 Other considerations in part 1

After determining which statements must be prepared, we can move on to discussing various facets of part 1 of the standard.

The first part of the standard addresses general considerations for preparing the financial statements, along with instructions on how to present and disclose foreign currency transactions and account for external assistance. The standard covers all facets of accounting under the cash basis.

We will consider each of these in turn.

1.2.4.1 Reporting period

The financial statements should be presented at least annually. When, in exceptional circumstances, an entity's reporting date changes and the annual financial statements are presented for a period longer or shorter than one year, the entity should disclose the reasons for a period of that one year being used and that fact that comparative amounts may not be comparable.

1.2.4.2 Timeliness

Financial statements should be made available within a reasonable period after the reporting date. The standard suggest that an entity should be in a position to issue its financial statements within six months of the reporting date, although a timeframe of no more than three months is strongly encouraged.

1.2.4.3 Presentation

Presentation and classification of items in the financial statements should be consistent from one period to the next unless:

- A significant change in the nature of the operations of the entity or a review of its financial statements presentation demonstrates that the change will result in a more appropriate presentation of events or transactions; or
- A change in presentation is required by a future amendment to the Standard.

The financial statements should be clearly identified and distinguished from other information in the same published document.

Interactive Question 1.6 Consistency

Which of the following scenarios, as per Cash Basis IPSAS, allows for change to the way items are presented and categorized in the statements of cash receipts and payments and the comparison of budgeted and actual amounts?

(a) A hospital reviews its financial statements and concludes that a change will result in a more appropriate presentation of events or transactions.

(b) A government reorganisation results in a municipal authority losing responsibility for providing education and housing services in its local area, which previously accounted for 70% of its revenue and expenses.

(c) A university changes its student assessment procedures from being mainly exam based to 50% coursework based.

See **Answer** at the end of this chapter.

1.2.4.4 Errors

When an error arises in relation to a cash balance reported in the financial statements, the amount of the error that relates to prior periods should be reported by adjusting the cash at the beginning of the period. Comparative information should be restated unless it is impracticable to do so. Details of the error should be disclosed in the notes to the financial statements.

Worked example: Errors

The Fishery Agency has prepared a draft statement of cash receipts and payments for the year-ended 31 December 20X3 as follows:

	Receipts / payments controlled by the entity
	£'000
Cash receipts	1,982
Cash payments	(1933)
Increase / (decrease) in cash	**49**
Cash at beginning of the year	127
Cash at end of the year	**176**

Since preparing this information, it was discovered that cash payments for the prior year (year ended 31 December 20X2) had been overstated by BDT75,000, and as a result the closing cash balance shown above is understated by BDT75,000. During the year ended 31 December 20X3, third party payments of BDT167,000 were made by a central government department on behalf of the agency.

Requirement

Prepare a corrected statement of cash receipts and payments for the year- ended 31 December 20X3.

Solution to worked example

We need to correct prior year error by amending opening cash balance and so the BDT75,000 overstatement of cash payments in the previous year will increase the closing cash balance but not affect the overall increase in cash during the year.

The overall cash movement is unchanged from the amount shown in question because the error does not affect the current year, and the third party payment is both an inflow and an outflow.

Cash at the beginning and end of year needs to be increased by BDT75,000.

The revised statement will therefore be as follows:

	Receipts / payments controlled by the entity	3rd party receipts/ payments
	£'000	£'000
Cash receipts	1982	167
Cash payments	(1933)	(167)
Increase / (decrease) in cash	**49**	**0**
Cash at beginning of the year	202	
Cash at end of the year	**251**	

Note that any comparative information shown for the prior year would be restated to remove the BDT75,000 overstatement of payments.

1.2.4.5 Other disclosures

The date of authorisation for issue and who gave that authorisation should be disclosed. Information about the entity should be disclosed. For example, domicile, legal form, jurisdiction, description of principal activities, relevant governing legislation and name of controlling entity. The following must be disclosed:

- Significant cash balances not available for use by the entity, for example if a controlled entity operates in a country where exchange controls or other restrictions apply.
- Significant cash balances that are subject to external restrictions; for example if a grant or donation is received for a specific purpose.
- Undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities. Undrawn borrowings represent a potential source of cash for an entity so disclosure allows users of the accounts to assess the availability of such cash and the extent to which the entity has made use of the course in the period.

1.3 Transition of cash basis to accrual basis accounting

IPSASB Study 14: Transition to the Accrual Basis of Accounting: Guidance for Public Sector Entities

Transition to IPSAS covers a wide range of situations:

- Stage 1: Moving from non-IPSAS-compliant cash accounting to IPSAS cash accounting;
- Stage 2: Moving from IPSAS cash accounting to full accrual accounting under IPSAS;
- Stage 3: Moving from modified accrual-based accounting or some accrual accounting standards to full accrual accounting under IPSAS.

These three situations require proper project management. However, each of these three situations has its own specificities and needs a specific technical approach. Stage 1 is the most critical stage. Stage 2 and Stage 3 cannot be accomplished as long as Stage 1 is still pending.

Cash accounting is not a well-developed accounting and reporting system, but it lays the foundations for accounting.

In order to implement IPSAS cash accounting it is necessary to implement procedures and systems (sometimes IT systems, but IT is not mandatory) to make sure that entity (usually a country) recognizes all cash in and all cash out. It means that the entity is building an internal control system to make sure that cash in and cash out are measured reliably, to prevent fraud and errors.

In addition to IPSAS and Recommend Practice Guidelines (RPG), the IPSASB also occasionally issues studies, which provide advice on financial reporting issues in the public sector. One such study is useful to consider during our coverage of the cash basis reporting: IPSASB Study 14 Transition to the Accrual Basis of Accounting: Guidance for Public Sector Entities (IPSASB, 2011).

This study was designed to assist public sector entities transitioning from the cash to accrual basis of accounting although will also be of use to entities currently reporting on the accrual basis and considering the adoption of IPSASs and entities complying with the requirements of the Cash Basis IPSAS and disclosing certain accrual basis information.

In the study, the IPSASB outlines the benefits of using an accruals-based accounting system, stating that reports prepared on an accruals basis allow users to:

Assess the accountability for all resources the entity controls and the deployment of those resources;

- Assess the financial position, financial performance, and cash flows of the entity; and
- Make decisions about providing resources to, or doing business with, the entity.

At a more detailed level, reporting on an accrual basis of accounting:

- Shows how an entity financed its activities and met its cash requirements;
- Allows users to evaluate an entity's on-going ability to finance its activities and to meet its liabilities and commitments;
- Shows the financial position of an entity and changes in financial position;
- Provides an entity with the opportunity to demonstrate successful management of its resources; and
- Is useful in evaluating an entity's performance in terms of its service costs, efficiency, and accomplishments.

The study outlines the process for managing the transition from cash to accruals based accounting, outlining factors which will affect the nature and speed of the transition such as the level of political commitment to the adoption of accrual accounting and the capacity and skills of relevant people and organisations. Key factors which must be considered when planning the transition process include the impact on budget control procedures and the extent to which financial information can be audited during the transitional period.

Interactive Question 1.7 Additional Exercise

Requirement

Compare accounting under the cash basis with accounting under the accruals basis, listing the advantages and disadvantages of each.

See **Answer** at the end of this chapter.

1.4 IPSAS: Financial Reporting under Accrual basis accounting

Accrual Basis IPSAS

Earlier in this chapter of the workbook a list of IPSAS has been presented. The list (see section 1.1.1) presents the corresponding IFRS. As this workbook discuss the IFRS with their application in details, this section focus on some unique IPSAS only. This chapter focuses on three IPSAS-

1) IPSAS 22 Disclosure of Financial Information about the General Government Sector
2) IPSAS 23 Revenue from Non-Exchange Transactions (Taxes and Transfers)
3) IPSAS 24 (Presentation of Budget Information in Financial Statements)

1.4.1 IPSAS 22

Disclosure of Financial Information about the General Government Sector

The objective of this standard is to prescribe disclosure requirements for governments which elect to present information about the general government sector (GGS) in their consolidated financial statements. The disclosure of appropriate information about the GGS can enhance the transparency of financial reports, and provide for a better understanding of the relationship between the market and non-market activities of the public sector and between financial statements and statistical bases of financial reporting.

Contents

IPSAS 22 discusses key definition, scope, financial statements for the government and statistical bases of financial reporting, Accounting policies for the general government sector and disclosure in notes.

Disclosures made in respect of the general government sector must include at least the following:

a) Assets by major class, showing separately the investment in other sectors
b) Liabilities by major class
c) Net assets/equity
d) Total revaluation increments and decrements and other items of revenue and expense recognized directly in net assets/equity
e) Revenue by major class
f) Expenses by major class
g) Surplus or deficit
h) Cash flows from operating activities by major class
i) Cash flows from investing activities
j) Cash flows from financing activities

According to IPSAS 22.40, entities preparing general government sector disclosures must disclose the significant controlled entities that are included in the general government sector. IPSAS 22 also requires disclosures on changes in those entities from the prior period, together with an explanation of the reasons why any such entity that was previously included in the general government sector is no longer included.

1.4.2 IPSAS 23

Revenue from Non-Exchange Transactions (Taxes and Transfers)

1.4.2 Overview

The objective of IPSAS 23 is to prescribe requirements for the financial reporting of revenue arising from non-exchange transactions, other than non-exchange transactions that give rise to an entity combination. The standard deals with issues that need to be considered in recognizing and measuring revenue from non-exchange transactions including the identification of contributions from owners.

While the revenue of public sector entities stems both from exchange and non- exchange transactions, most transactions at public sector entities are non-exchange transactions. In particular, these include revenue from taxes and transfers (both cash and non-cash transfers).

One of the main characteristics of public sector entities as a whole is that:

- a major part of their revenue is received as taxation or other mandatory payments by citizens or companies, rather than being paid in exchange for good and services. Many public sector bodies also receive donations or grants:
- a major part of their expenditure involves making payments or providing services for no fee, a nominal amount, or an amount which will not recover costs. These may include payments to relieve poverty, debt forgiveness and other social expenditures.

These 'non-exchange transactions', in which the parties do not make exchanges of approximately equal value, are a characteristic feature of public sector financial reporting. Non-exchange transactions arise rarely if at all in the private sector, and consequently there is no IFRS covering non-exchange transactions.

> **Key definition:** Non-exchange transactions Non-exchange transactions are transactions that are not exchange transactions. In a non- exchange transaction, an entity either receives value from another entity without directly giving approximately equal value in exchange, or gives value to another entity without directly receiving approximately equal value in exchange.

After considering such transactions, the IPSAS Board developed a standard to prescribe the financial reporting requirements of revenue arising from non-exchange transactions. The standard, IPSAS 23, was issued in December 2006.

1.4.2.1 IPSAS 23 Revenue from Non- Exchange transactions

The objective of IPSAS 23 Revenue from non-exchange transactions (Taxes and Transfers) is to set out requirements for the financial reporting of non-exchange revenue. IPSAS 23 applies to revenues from the following transactions and events:

- taxes, from whatever source
- other non-exchange revenue (called 'transfers' in the standard), such as grants, fines, bequests, gifts, donations, goods and services in-kind.

IPSAS 23 does not apply to:

- revenue from exchange transactions
- entity combinations
- changes in fair value of financial instruments and other assets
- agriculture assets.

In a non-exchange transaction an entity (or an individual) receives assets either without directly paying for them, or without paying for them in full (i.e., at a subsidised price).

1.4.2.2 Recognition

The same principles apply to the recognition of revenue from non-exchange transactions as to other revenue. Revenue collected on behalf of third parties (including other government organisations) is not counted as part of the entity's revenue. Revenue is recognised when:

- it is probable that future economic benefits or service potential will flow to the entity
- the amount of revenue can be measured reliably.

The principle underlying the recognition of revenue from non-exchange transactions is that if an entity receives an asset in a non-exchange transaction it recognises revenue of the same amount, provided that the asset can be measured reliably.

Assets are defined in IPSAS 1 as resources controlled by an entity as a result of past events and from which economic benefits or service potential are expected to flow to the entity.

In the case of a public sector entity, assets arising from non-exchange transactions can take a number of forms including:

- cash and cash receivable;
- other assets or receivables which provide economic benefit; and
- assets or assets receivable which have service potential.

Under accruals accounting, the public sector entity will recognise revenue when it directly exercises control over these resources, or has reliable information on enforceable claims on these resources.

Non-exchange revenue will typically include:

- donations;
- surrenders of taxes;
- accounts receivable based on invoices, for example for fines levied on offenders, or for settlement of tax balances;
- accounts receivable from contracts or binding agreements, including grants from another level of government or from international donors, and;
- estimates of taxes due based on estimates of the economic activity which gives rise to a requirement to pay tax.

Revenue should only be recognised when control has passed to the receiving entity, on the basis of information which is sufficiently reliable. Pledges, promises or announcements of intention to pay are not generally regarded as sufficient to ensure an enforceable claim and thus control of an asset.

There are three important situations where assets received are not reflected as non-exchange revenue.

1. <u>Contributions from owners:</u> These are disclosed separately and are not part of revenue. These occur when a 'contributing' entity provides and designates funding or other assets as being a permanent contribution, establishing a financial interest in the net assets/equity of the receiving entity.
2. <u>Advance receipts:</u> An entity may receive an asset, generally cash, in advance of the period for which it was intended. Such advance receipts relate generally to taxes but IPSAS 23

also gives an example of annual contributions received in the preceding year. In line with standard accruals principles, these advance receipts are treated as a liability until the taxable or other event triggering recognition occurs, and only at that point is revenue recognised.

3. Assets with linked obligations: The receipt of assets may give rise to a present obligation, in the form of a duty to act or perform in a certain way. In some cases this will indicate that the asset has been exchanged for acceptance of an obligation, and normal accounting for exchange transactions should be followed. In other cases it is more helpful to treat the asset as being received as a non-exchange transaction, but to recognise a balancing liability in respect of the obligation. For example, a grant may have been provided by a donor agency to improve and maintain a tramway system. If such a condition is set, the recipient has an obligation to spend the money in this way and therefore a liability exists to incur such expenditure or to return the money received. This is described in more detail later.

Interactive Question 1.8

According to IPSAS 23, an organization is required to recognize revenue from non-exchange transactions if it obtains an asset that can be accurately assessed, with some exclusions made for owner contributions, upfront payments, and current commitments.

Requirement

Which ONE of the following receipts would constitute revenue for the year ended December 20X1?

a) A receipt in December 20X1 for property tax for the year 20X2.

b) A receipt from another government body which must be repaid after ten years and on which annual interest will be charged.

c) A receipt for a grant which has the condition that it must be spent on specific designated projects or returned to the donor.

d) A donation from a local resident towards local services.

See **Answer** at the end of this chapter.

1.4.2.3 Measurement

In line with standard requirements for recognition of revenue, it is necessary that the asset received and controlled by the entity can be measured reliably.

Assets acquired through non-exchange transactions are measured at their fair value at the date of acquisition. Revenue is valued at the amount of the increase in assets, less any associated liability attached to the asset. Many such assets are in the form of cash received immediately or within a short period, and establishment of fair values will be straightforward. As with all receivables, questions of collectability due to disputes and delays in payments may need to be addressed. Liabilities relating to present obligations also need to be valued. Where non-performance of the obligation would in principle require the asset to be returned, these are generally valued at an amount equal to the asset value. The liability will be reduced when the event or events occur to discharge the obligation and these will also trigger revenue recognition.

1.4.3.4 Revenue from taxes

IPSAS 23 defines taxes as economic benefits or service potential compulsorily paid or payable to public sector entities, in accordance with laws and/or regulations, established to provide revenue to the government. Taxes do not include fines or other penalties imposed for breaches of the law. Taxes are a major source of revenue for many governments and public sector entities.

Taxes vary significantly from jurisdiction to jurisdiction, but have many common characteristics. Laws and regulations establish a government's right to collect tax, and identify the basis on which tax is calculated. They also typically require taxpayers to provide evidence of the level of activity subject to tax, on the basis of which the amount of tax is calculated. Tax laws are usually rigorously enforced and often impose penalties on individuals or other entities breaching the law.

The taxable event is the event that the government, legislature, or other authority has determined will be subject to taxation.

The taxable event will vary according to the type of tax levied and IPSAS 23 provides a list of typical cases as follows:

- Income tax - earning of assessable income during the taxation period by the taxpayer
- Value added tax - undertaking of taxable activity during the taxation period by the taxpayer
- Goods and services tax - purchase or sale of taxable goods or services during the taxation period
- Customs duty - movement of dutiable goods or services across the customs boundary
- Death duty - death of a person owning taxable assets
- Property tax - passing of the date on which the tax is levied, or the period for which the tax is levied, if the tax is levied on a periodic basis.

IPSAS 23 requires that assets arising from taxation transactions be measured at their fair value as at the date of acquisition. Assets arising from taxation transactions are measured at the best estimate of the inflow of resources to the entity.

IPSAS 23 describes key features of taxation issues in many jurisdictions which may serve to delay settlement of tax and make the level of settlement uncertain and may require the development of statistical models or other estimation approaches. These include the long periods allowed for filing of returns, failures to file returns by the due date, complexities in tax law and inherent problems in gathering relevant information.

Due to the need for governments to maintain cash flows from tax receipts, it is normal for tax authorities to require payments in advance, particularly from self-employed persons and businesses. IPSAS 23 makes it very clear that the very significant volume of advance tax receipts encountered in many jurisdictions should not be recognised as revenue until the tax is properly due. Governments applying accruals accounting should recognise tax revenue in line with the taxable events, applying tax rates to taxable income or assets.

The tax area is one where many (perhaps most) governments face significant practical difficulties in producing reliable estimates of total tax due and the likely level of bad debts. In many jurisdictions governments will not be able to estimate these even after collection processes have been completed; they may only be able to objectively and reliably measure the net amount of taxes collected.

Furthermore, governments will often face additional constraints from limitations in the systems used to collect and account for tax receipts (whether their own or systems used by other entities collecting tax on behalf of government), which may not provide sufficient information on the period to which tax receipts relate.

For the reasons set out above, many governments either do not account for tax revenue on an accruals basis, or provide accruals information which is limited due to difficulties in producing reliable estimates. IPSAS 23 recognises the difficulties and requires disclosure of information on 'missing' tax revenue.

Taxation revenue is determined at a gross amount. It should not be reduced for expenses paid through the tax system (such as family welfare benefits that might otherwise be paid direct to individuals who are not taxpayers), nor should it be grossed up for the amount of tax expenditures (such as personal tax allowances that are available only to taxpayers).

1.4.2.5 Transfers

IPSAS 23 defines transfers as inflows of future economic benefits or service potential from non-exchange transactions, other than taxes. IPSAS 23 applies the same recognition principles to other non-exchange revenue, that is, a public sector entity recognises an asset when the asset recognition criteria (including control, expectation of future economic benefits or service potential and reliable measurement) are met. Revenue is only recognised to the extent that a gain from the asset value is not reduced by an associated liability.

Transfers include grants, fines, bequests, gifts, donations, debt forgiveness, and goods and services in-kind. All these items have the common attribute that they transfer resources from one entity to another without providing approximately equal value in exchange, and are not taxes as defined in IPSAS 23. We shall consider each type of transfer in turn.

(a) Grants

Although grants are not defined in IPSAS 23, they represent a significant type of revenue from non-exchange transactions. Grants are frequently provided from one level of government to another or from donor agencies to governments.

Grants are often provided with limitations ('stipulations') on how money should be spent or assets utilised. The standard separates such stipulations into:

- **conditions**, where the money must be spent as specified or returned to the donor (in other words a performance obligation); and
- **restrictions**, where there is a more general requirement to spend the money in a specified area but not to return it if this is not achieved.

Key definitions:

Stipulations on transferred assets

Stipulations on transferred assets are terms in laws or regulation, or a binding arrangement, imposed upon the use of a transferred asset by entities external to the reporting entity.

Conditions on transferred assets

Conditions on transferred assets are stipulations that specify that the future economic benefits or service potential embodied in the asset is required to be consumed by the recipient as specified or future economic benefits or service potential must be returned to the transferor.

Restrictions on transferred assets

Restrictions on transferred assets are stipulations that limit or direct the purposes for which a transferred asset may be used, but do not specify that future economic benefits or service potential is required to be returned to the transferor if not deployed as specified.

This distinction may not always be clear cut and it is necessary to consider the substance of the stipulation and not merely its form. This might take into account:

- the likelihood of enforcement;
- prior experience with the donor;
- the extent of specification of detailed requirements; and
- the degree of monitoring by the donor.

Where the recipient entity considers that the donor has imposed conditions they will set up a liability for the obligation, generally to the value of the money received, which will be reduced as the conditions are satisfied (by spending the money or through other actions) in accordance with the agreement.

There is no such requirement for grants with restrictions, and revenue is recognised immediately.

Worked example: Conditions vs. restrictions

A national government makes a cash transfer of BDT50 million to a state government housing agency, specifying that it must use the cash transfer either to support its existing social housing objectives or towards new objectives which are in line with national housing priorities.

A BDT77 million cash transfer from the federal government to a state government housing agency is made, with the stipulation that the agency must use the funds for new or existing social housing goals that align with national housing priorities.

If this objective is not satisfied, the recipient entity must return the cash to the national government. How would this be accounted for in the housing entity's financial statements?

Solution to worked example

The state government social housing entity recognises an increase in an asset (cash) and revenue in the amount of BDT77 million. The stipulations in the transfer agreement are stated so broadly that they do not impose on the recipient a performance obligation – the performance obligation is imposed by the operating mandate of the entity, not the terms of the transfer.

Interactive Question 1.9 (Grant)

A university (reporting entity) receives 450 acres of property in a large city from the national government (transferor) in order to develop a campus. The land must be used for a campus, as stated in the transfer agreement; however, it is not stated that the land must be returned if it is not needed for a campus.

Requirement

How should the university account for the transaction?

See **Answer** at the end of this chapter.

(b) Fines

Fines are economic benefits or service potential received or receivable by public sector entities, as determined by a court or other law enforcement body, as a consequence of the breach of laws or regulations.

(c) Bequests

A bequest is a transfer made according to the provisions of a deceased person's will. According to IPSAS 23.90, the past event giving rise to the control of resources embodying future economic benefits or service potential for a bequest occurs when the entity has an enforceable claim, for example on the death of the testator, or the granting of probate, depending on the laws of the jurisdiction. Bequests which satisfy the definition of an asset and meet the recognition criteria are recognized as assets. Determining the probability of an inflow of future economic benefits or service potential may be problematic if a period of time elapses between the death of the testator and the entity receiving any assets. Bequests are generally measured at fair value at the date of acquisition.

(d) Gifts and donations

Gifts and donations are voluntary transfers of cash or other assets to an entity. Gifts and donations are generally recognised on receipt of the cash or other asset. The accounting entry is to debit the asset (cash or other asset such as property, plant and equipment) and credit revenue. Where the asset is not cash, for example the donation of a house or work of art to a government entity, the asset and revenue will be recognised at fair value. Pledges to give in the future are not generally recognised as they are not controlled by the entity, but may warrant disclosure as a contingent asset. As with grants and bequests, gifts and donations may be subject to stipulations as to how the money or assets are to be spent or utilised.

Interactive Question 1.10 (Donation):

A local television station holds a fundraising appeal for a public hospital (reporting institution) on the evening of December 31, 20X0. The public hospital's yearly reporting date is December 31. Viewers of television make phone calls or send emails pledging to donate a certain amount of money. BDT4 million has been pledged at the end of the appeal. The people making the promise are not obligated to make the donations. Previous appeal experience suggests that roughly 75% of donations that are committed will be made.

Requirement

How should the public hospital account for the pledged donations?

See **Answer** at the end of this chapter.

(e) Debt forgiveness

Lenders may waive their right to collect a debt owed by a public sector entity, thus effectively cancelling the debt. In such a case the entity has an increase in net assets/equity and treats the amount forgiven as revenue from a non-exchange transaction.

(f) Services in-kind

Services in-kind are voluntary services provided to an entity by an individual or individuals. Such services may include free technical assistance from other governments or international organisations, voluntary work in schools and hospitals or community services performed by convicted offenders.

The standard provides that entities may, but are not required to, recognise services in-kind as revenue and expenditure where the amount can be measured, is material and its inclusion enhances the presentation of the financial statements. Disclosure of the nature of significant in-kind services in all cases is encouraged.

Worked example: Services in-kind

A hospital employs the following staff:

- a medical student from university during vacation periods on a voluntary basis, who carries out a variety of jobs in various departments to gain work experience
- a trained nurse whose salary is paid by an international agency, who works within standard procedures and whose work is assessed as of equal quantity and quality as that of local nursing staff.

How would this be accounted for in the hospital's financial statements?

Solution to worked example

It is unlikely that the services of the medical student would be recognised in the financial statements, as it will normally be difficult to assess the value of this work. There is a better case for recognition of the work of the trained nurse, especially if there are several such staff whose total contribution is material. The valuation of the work might be based on, for example, the salary rate of the local staff who do equivalent work.

1.4.2.6 Disclosure

IPSAS 23 requires disclosure of the following:

- the accounting policies for the recognition of revenue from non-exchange transactions, including for major classes, the basis of assessing fair value
- information about the nature of taxes which cannot be measured reliably and are therefore not recognized
- the nature and types of major classes of bequests, gifts and donations
- the amount of revenue from taxation, split by major classes
- the amount of other revenue/transfers from non-exchange transactions, split by major classes
- the amount of receivables recognised in respect of revenue from non-exchange transactions
- the amount of liabilities associated with amounts received with conditions and from advance payments as well as liabilities forgiven
- the amount of assets subject to restrictions.

The disclosure of information about services in-kind is encouraged.

1.4.3 IPSAS 24

Presentation of Budget Information in Financial Statements

A discussion on IPSAS 24 has been presented in the section of cash basis IPSAS in this workbook. In general IPSAS 24 provides that all comparisons of budget and actual amounts must be presented on a comparable basis to the budget (cf. IPSAS 24.31). According to IPSAS 24.21, an entity must present a comparison of budget and actual amounts as additional budget columns in the primary financial statements only where the financial statements and the budget are prepared on a comparable basis. For example, if the budget is prepared on the cash basis and the financial statements are prepared on the accrual basis, no comparison as additional budget columns is necessary. If the financial statements and the budget were prepared on a comparable basis, additional columns can be added to the existing primary financial statements presented in accordance with IPSASs.

1.4.3 The statement of comparison of budget to actual amounts (IPSAS 24)

1.4.3.1 Overview

Appropriation laws, which are legislative measures, are the means by which budgets in the public sector are authorized. A public sector organization is authorized by the appropriations law to use public funds, primarily obtained through taxes, for a certain purpose during the fiscal year. Usually, these budgets are released into the public domain. **The standard mandates (IPSAS 24)** that entities incorporate budget information in the financial statements, acknowledging the significance of budgets in the public sector. **This standard is relevant both for the Cash basis and accrual basis accounting.**

The standard mandates that this information be included in the financial statements when an institution makes its budget available to the public. The budget amount should be compared to the actual amount. This may be as a separate financial statement or, if the financial statements and budget are prepared on a comparable basis, as additional budget columns in the statement of cash receipts and payments.

The comparison should include:

- The original and final budget amounts;
- The actual amounts on a comparative basis; and
- A disclosure note explaining any material variations between budget and actual amounts.

Where the financial statements and budget are not prepared on a comparable basis, there should be a reconciliation of actual amounts to total cash receipts and payments as shown on the face of the statement of cash receipts and payments.

The disclosure of comparative budget information in respect of the previous period is not required.

1.4.3.2 Key Definition

Key definitions (IPSAS 24):

Annual budget

Annual budget means an approved budget for one year. It does not include published forward estimates or projections for periods beyond the budget period.

Approved budget

Approved budget means the expenditure authority derived from laws, appropriation bills, government ordinances and other decisions related to the anticipated revenue or receipts for the budgetary period.

Budgetary basis

Budgetary basis means the accrual, cash or other basis of accounting adopted in the budget that has been approved by the legislative body.

Comparable basis

Comparable basis means the actual amounts presented on the same accounting basis, same classification basis, for the same entities and for the same period as the approved budget.

Final budget

Final budget is the original budget adjusted for all reserves, carry over amounts, transfers, allocations, supplemental appropriations, and other authorised legislative or similar authority changes applicable to the budget period.

Original budget

Original budget is the initial approved budget for the budget period.

1.4.3.3 Classification of cash flows

The illustration below shows the format of a statement of comparison of budget and actual amounts for a government using a classification of payments by function.

Interactive Question 1.11 (Classification of cash flows)

Requirement

Explain an alternative classification basis, other than by function, that could be used for cash outflows and what are the main headings that would appear in the statement using this alternative classification.

See **Answer** at the end of this chapter.

Statement of comparison of budget and actual amount

For Government X for the Year Ended December 31, 200X

Budget approved on the cash basis

Classification of payments by function

	Actual Amount	Final Budget	Original Budget	Difference Actual-Final
CASH INFLOWS				
Taxation	X	X	X	X
Aid agreements	X	X	X	X
International agencies	X	X	X	X
Other grants and aid	X	X	X	X
Proceeds – borrowing	X	X	X	X
Proceeds – disposals	X	X	X	X
Trading activities	X	X	X	X
Other receipts	X	X	X	X
Total receipts	**X**	**X**	**X**	**X**
CASH OUTFLOWS				
Health	(X)	(X)	(X)	(X)
Education	(X)	(X)	(X)	(X)
Public order and safety	(X)	(X)	(X)	(X)
Social protection	(X)	(X)	(X)	(X)

Defence	(X)	(X)	(X)	(X)
Housing and community	(X)	(X)	(X)	(X)
Recreation, culture and religion	(X)	(X)	(X)	(X)
Economic affairs	(X)	(X)	(X)	(X)
Other	(X)	(X)	(X)	(X)
Total payments	**(X)**	**(X)**	**(X)**	**(X)**
NET CASH FLOWS	**X**	**X**	**X**	**X**

1.4.3.4 Preparing the comparison of budget and actual amounts

Here is a pro forma of the statement:

Statement of comparison of budget and actual amounts

	Actual	Final budget	Original budget	Difference Actual-final
Cash inflows:				
Total receipts				
Cash outflows:				
Total payments				
Net cash flows				

How the statement is prepared is shown in a worked example below;

Worked example: Comparison of budget and actual amounts (Department of Agriculture).

The statement of comparison between the Department of Agriculture's budget and actual amount for the year that ended on December 31, 20X0, will be prepared in this worked example.

In addition to the information given in the worked example in **section 1.2.3.3** for the Department for Agriculture, the following information is available. The original budget for the year ended 31 December 20X0 was as follows:

Receipts – Original budget	**BDT'000**	**Payments - Original budget**	**BDT'000**
Funding allocations	47,589	Wages, salaries and employee benefits (including directors)	47,859
Proceeds from borrowing	6,003	Supplies and consumables	1,700
Receipts from trading activities	1,500	Rent	590
Proceeds from disposal of property, plant and equipment	-	Purchase of property, plant and equipment	4,800
Interest received	18	Repayment of borrowings	78
		Interest payments	38
Total receipts	**55,110**	**Total payments**	**55,065**

The following amendments were made to the original budget during the year as a result of unexpected operational problems:

- The budgeted funding allocation had to be increased by BDT1.5m.
- Budgeted proceeds from borrowing were increased by BDT2.3m.
- Budgeted payments for the purchase of property, plant and equipment were increased by BDT3m.

You are required to prepare the department's statement of comparison of budget and actual amount for the year-ended December 31 20X0.

Solution to worked example

Refer back to the information relating to the Department of Agriculture worked example. The amounts included in your statement of total cash receipts and cash payments for the year forms the starting point for preparing the statement of comparison of budget and actual amounts for the department as this gives us our first column, i.e. actual. Note that there is a single actual column which is a total of both cash and third party payments. We can therefore begin by setting up the pro forma and completing the first column as follows.

Note that the final column ('Difference') is not a requirement of the IPSAS but the IPSAS does allow it to be included, and it makes the information more easily understood by users of the financial statements.

Note also that the BDT750,000 third party salary payment is added in to the 'Actual' column.

Department of Agriculture

Statement of comparison of budget and actual amounts for the year ended 31 December 20X0

	Actual Amount	Final Budget	Original Budget	Difference Actual-Final
Cash inflows				
Funding allocations (47,592 + 750)	48,342			
Proceeds from borrowing	8,392			
Receipts from trading activities	2,158			
Proceeds from disposal of property, plant and equipment	287			
Interest received	22			
Total receipts	**59,201**			
Cash out flows				
Wages, salaries and employee benefits (including directors) (46,760 + 750)	(47510)			
Supplies and consumables	(1829)			
Rent	(568)			
Purchase of property, plant and equipment	(7800)			
Repayment of borrowings	(39)			
Interest payments	(102)			
Total payments	**(57848)**			
Net cash flows	**1,353**			

The next step is to insert the 'Original budget' column amounts, as these are given in the question and require no calculations.

You can then insert the relevant balances in the 'Final budget' column, ensuring that you make the relevant adjustments from the original budget as detailed in the question.

Finally, you can compare the actual amounts to the final budget in order to complete the 'Difference' column. This gives the following:

Department of Agriculture

Statement of comparison of budget and actual amounts for the year ended 31 December 20X0

	Actual Amount	**Final Budget**	**Original Budget**	**Difference Actual-Final**
	BDT'000	**BDT'000**	**BDT'000**	**BDT'000**
Cash inflows				
Funding allocations (Final = 47,589 + 1,500)	48342	49089	47589	(747)
Proceeds from borrowing (Final=6,003+2,300)	8392	8303	6003	89
Receipts from trading activities	2158	1500	1500	658
Proceeds from disposal of property, plant and equipment	287	-	-	287
Interest received	22	18	18	4
Total receipts	**59201**	**58910**	**55110**	**291**
Cash out flows				
Wages, salaries and employee benefits (including directors) (46,760 + 750)	(47510)	(47859)	(47859)	349
Supplies and consumables	(1829)	(1700)	(1700)	(129)
Rent	(568)	(590)	(590)	22
Purchase of property, plant and equipment (Final=4,800+35,000)	(7800)	(7800)	(4800)	-
Repayment of borrowings	(39)	(78)	(78)	39
Interest payments	(102)	(38)	(38)	(64)
Total payments	**(57848)**	**(58065)**	**(55065)**	**217**
Net cash flows	**1353**	**845**	**45**	**508**

Interactive Question 1.12 Statement of comparison of budget and actual amounts (St Mary Hospital)

Refer to the information relating to St Mary Hospital in **interactive question 1.5.** The following additional information is available. The hospital's original budget for the year was as follows:

Receipts	**BDT'000**	**Payments**	**BDT'000**
Funding allocations	9,050	Wages, salaries and employee benefits	9,830
Proceeds from borrowing	1,300	Medicines, supplies and consumables	1,700
Private patient and other income	2,150	Utilities	95
Proceeds from disposal of property, plant and equipment	57	Purchase of property, plant and equipment	768
Interest received	9	Repayment of borrowings	89
		Interest payments	42
Total receipts	**12,566**	**Total payments**	**12,524**

The final budget was almost the same as the original budget with the exception that payments for wages, salaries and employee benefits had to be increased by 3% as a result of unexpected increase in pay rates. As a result of this, the budgeted funding allocation for the year was increased by 2.5%

Requirement

Prepare the hospital's statement of comparison of budget and actual amount for the year-ended 31 March 20X0.

See **Answer** at the end of this chapter.

1.4.3.5 Additional disclosure requirements

Disclosures are required for the following in relation to the comparison of budget and actual amounts:

- The period of the approved budget
- The entities included in the approved budget
- An explanation of the budgetary basis and classification basis adopted in the approved budget should be disclosed.
- An explanation of whether changes between the original and final budget are a consequence of reallocations within the budget, or of other factors. This may be by way of a disclosure note or in a separate report issued in conjunction with the financial statements.

1.5 Accounting Practices in Bangladesh

1.5.1 Current Practice in General Government of Bangladesh

Bangladesh government is following cash basis accounting following the Constitution of People's Republic of Bangladesh (section 80 to section 92). A number of reformations in Public Financial Management (PFM) have attempted to enrich the accounting systems of Bangladesh.

Public Financial Management (PFM) Reform

Public Financial Management (PFM) reform is a key factor for improving the governance, accountability and transparency in Bangladesh. The colonial era PFM system that Bangladesh inherited mainly orbited around following administrative orders. To improve the management of public resources, a series of public financial reform programs were undertaken since the 1990s onwards.

Prior to these reform initiatives, the public financial reporting systems was out of sync with international standards, not capable of generating high quality and timely fiscal information and budgeting was merely a number crunching exercise.

The second multi-year PFM Strategy 2016-21 was developed to build on the past reforms and learn from what has worked and what has not. The PFM Action Plan (2018-23) was approved by the Finance Ministry in 2018 to support implementation of the new PFM reform strategy. The Strategy sets out 5 strategic goals, the related objectives and priority reform actions. Under the 5 goals, there are 50 primary reform components derived from the PFM Strategy. These are prioritized under 14 reform components.

The objective of this key note is to focus on component number C-10: Financial Reporting. Particularly activity number 35: Improve the quality and timeliness of Government wide year-end fiscal reporting. This falls under Goal #4 : Promote Accountability through external scrutiny and transparency of the budget.

The two streams of accounts in public financial management are budgetary accounts and the financial accounts. Appropriation accounts are prepared from the budgetary accounts of the executing agencies.

The Controller General of Accounts (CGA) prepares the annual financial statements i.e. the consolidated appropriation accounts and the finance accounts which go the Honorable President and then Parliament with certification from the Auditor General. These documents are not made available to the public and these are eventually sent to the Public Accounts Committee. There is significant delay in this process due at least in part to the lateness of information being supplied by the self-accounting entities. The finance accounts are too voluminous with a high number of schedules and information overload. In terms of style and content these are not in sync with IPSAS. To mitigate these challenges certain activities have been identified in the PFM Action Matrix:

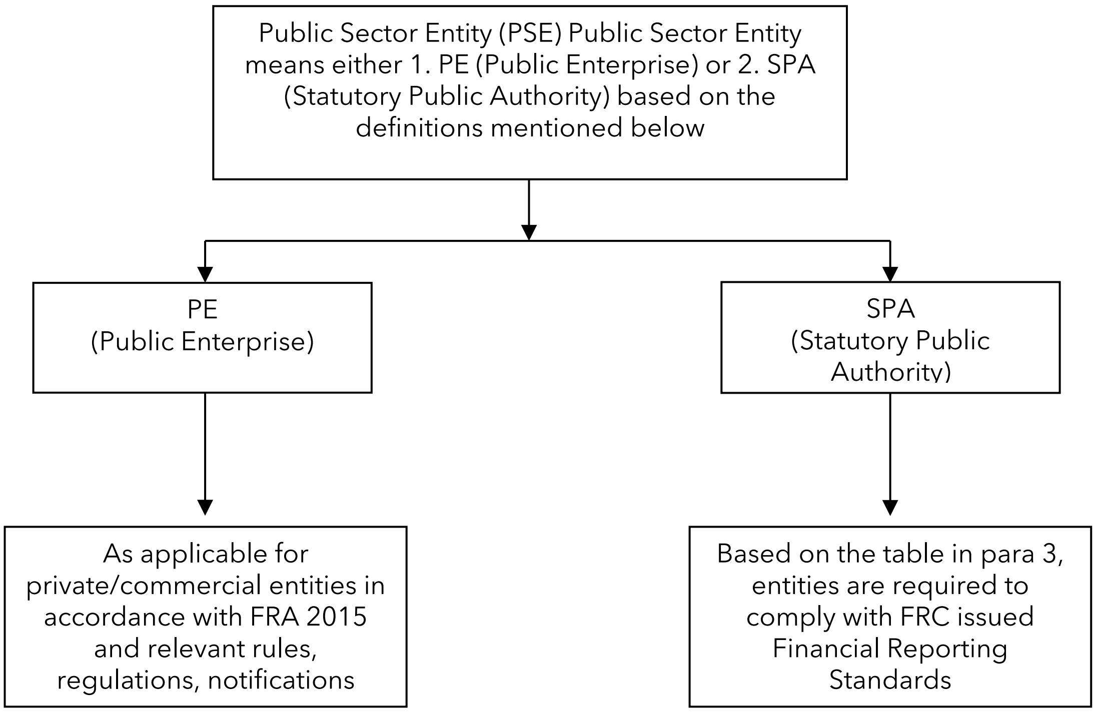
These are:

- Adopt Cash Basis IPSAS and provide disclosures based on requirements
- Collection of additional data to meet the disclosure requirement.
- Development of new template and its circulation across the entities
- Update the current accounting policy, procedures and manual
- Training the CGA and CAG Officials
- Improvement of timeliness of Annual closing procedures. Submitting government-wide annual financial statements, compliant with IPSAS cash basis, to OCAG within 3 months after the fiscal year end.

1.5.2 Reporting Requirements of Public Sector in Bangladesh

1. Financial Reporting Framework for Public Sector Entity (PSE) in Bangladesh

The Financial Reporting Framework governs which set of standards an entity must use for its Financial Reporting. The following flow chart summarizes which suite of standards applies:



Sources: Financial Reporting Framework, 2023, FRC, Bangladesh

2. Key Definition

As per Comptroller and Auditor-General (Additional Functions) Act, 1974 (Act No. XXIV of 1974), section (2)(cc)(d), definitions of PE and SPA are as follows-

2.1 PE (Public Enterprise) means a company or firm, incorporated or registered, in which the Government has at least fifty percent share or interest.

2.2 SPA (Statutory Public Authority) means any authority, corporation, or body the activities or the principal activities authorized by any Act, Ordinance, Order, or instrument having the force of law in

3. All PEs (Public Enterprise) should follow standards applicable for other private/ commercial entities by FRA 2015 and relevant rules, regulations, and notifications. In the case of SPAs (Statutory Public Authority), entities should follow applicable standards as stated below. Under section 40 (4) of FRA, 2015, FRC is allowed to develop, and issue simplified standards.

Accounting Standards Framework for SPAs	
Standards	***Entities***
Level 1: IFRS*/ Accrual Basis IPSAS	o Large scale of operation (Revenue> BDT 100 crore)
Level 2: Simplified Accrual Basis IPSAS	o Big scale of operation (Revenue > BDT 50 crore) or o Elect to be in a higher level
Level 3: Simple Accrual Basis	o Medium scale of operation (Revenue ≤ BDT 50 crore) or o Elect to be in a higher level
Level 4: Modified Accrual Basis	o Small scale of operation (Revenue ≤ BDT 30 crore or gross assets > BDT 10 crore) or o Elect to be in a higher level
Level 5: Cash Basis	o Very small scale of operation (Revenue ≤ BDT 5 crore and gross assets not more than 10 crores) or o Elect to be in a higher level
"Revenue" is the total of income, gain, and grants recognized and measured by the appropriate level's standards for the preceding one (1) year of reporting period except for Level 5 revenue which should be determined based on Level 4 standards.	

Sources: Financial Reporting Framework, 2023, FRC, Bangladesh

4. Criteria of of different levels of Financial Reporting Formats (FRF) for SPAs

Stage	**Basis/ References**	**Statements to be included**	**Purpose/ Objectives**
Level 1	IFRS or Accrual Basis IPSASs – Published by IASB and IPSASB in 2022 and continuously updated.	1. Statement of Financial Position 2. Statement of Profit & Loss and Other Comprehensive Income 3. Statement of Changes in Equity 4. Statement of Cash Flows 5. Notes to the Financial Statements 6. Statement of Budget vs Actual	To fulfill the information expectation of all stakeholders administrative ministry, auditors, lenders, international agencies, WB, ADB, other regulators, suppliers, and service recipients of large SPAs.
Level 2	Simplified Accrual Basis IPSASs – Based on the SMEGA guideline published 1.by UN and IASB in 2004, updated by FRC as of 2022.	1. Statement of Financial Position 2. Statement of Comprehensive Income 3. Statement of Changes in Funds 4. Statement of Cash Flow 5. Notes to the Financial Statements 6. Statement of Budget vs Actual	Simplified but covering all the basic principles of IPSAS would make the Financial Statements of higher quality and deliver a better picture of an entity's performance and position in monetary terms.

Stage	Basis/ References	Statements to be included	Purpose/ Objectives
Level 3	Simple Accrual basis –Published by UN in 2009, updated by FRC as of 2022.	1. Balance Sheet 2. Income Statement 3. Cash Flow Statement 4. Notes to the Financial Statements 5. Statement of Budget vs Actual	Governmental agencies have two key objectives: to a) demonstrate whether resources are being used to provide the target audience with the services. B) And whether according to legally adopted budgets. An accrual basis will serve these purposes.
Level 4	Modified Accrual based on US Govt. Accounting Standard Board (GASB) issued Standards.	1. Balance Sheet 2. Income Statement 3. Statement of Receipts and Payments 4. Notes to the Financial Statements 5. Statement of Budget vs Actual	Modified accrual basis is a combination of both accrual and cash basis. This method helps entities to keep track of long-term assets and liabilities and simplifies the preparation of income statements. It will significantly help the gradual shift from cash to accrual.
Level 5	Cash basis-Prepared by FRC aligning with IPSAS Cash Basis Standard	1. Receipts & Payments (R&P) Statement 2. Notes to the R&P Statement 3. Statement of Budget vs Actual 4. Fixed Assets (FA) Schedule from FA Register	To bring uniformity, consistency, and discipline in financial reporting, FRC has prepared level 5 Cash Basis FRF for very small size entities.

Sources: *Financial Reporting Framework, 2023, FRC, Bangladesh*

Interactive Question 1.13 (Financial Reporting Framework 2023)

Recent assessment shows that Ministry of health yearly revenue is more than 50 crore taka.

Required:

Which statements are required to be prepared as per the financial reporting framework 2023 issued by FRC in Bangladesh?

See **Answer** at the end of this chapter.

1.6 Other Reporting (Statistical Reporting, Budget Related Reporting, Component Reporting)

Government accounting can integrate statistical reporting, budget related reporting, component reporting and others if there are common goal among the reporting. But, the reporting initiative may face challenges.

Components of a government include legally independent entities such as government business enterprises, as well as departments and off-budget funds. The latter are entities for which accounting records are kept, but national practices differ with regard to the preparation and publication of their financial statements.

In addition to preparing financial reports, a government's accounting system supplies data for the compilation of government finance statistics (GFS) and the System of National Accounts (SNA).

1.7 Integrated Financial Management Information Systems (IFMIS)

An IFMIS can be broadly defined as a "set of automation solutions that enable governments to plan, execute and monitor the budget, by assisting in the prioritization, execution, and reporting of expenditures, as well as the custodianship and reporting of revenues" (World Bank 2011). A narrower definition of an FMIS is the set of systems and procedures that automates the financial operations of both the budget preparation and treasury functions of government by recording all transactions, implementing controls and tracking financial events. The initial automation usually involves the general ledger (the final repository of accounting records and data) and the chart of accounts (the list of accounts used by governments for classifying expenses).

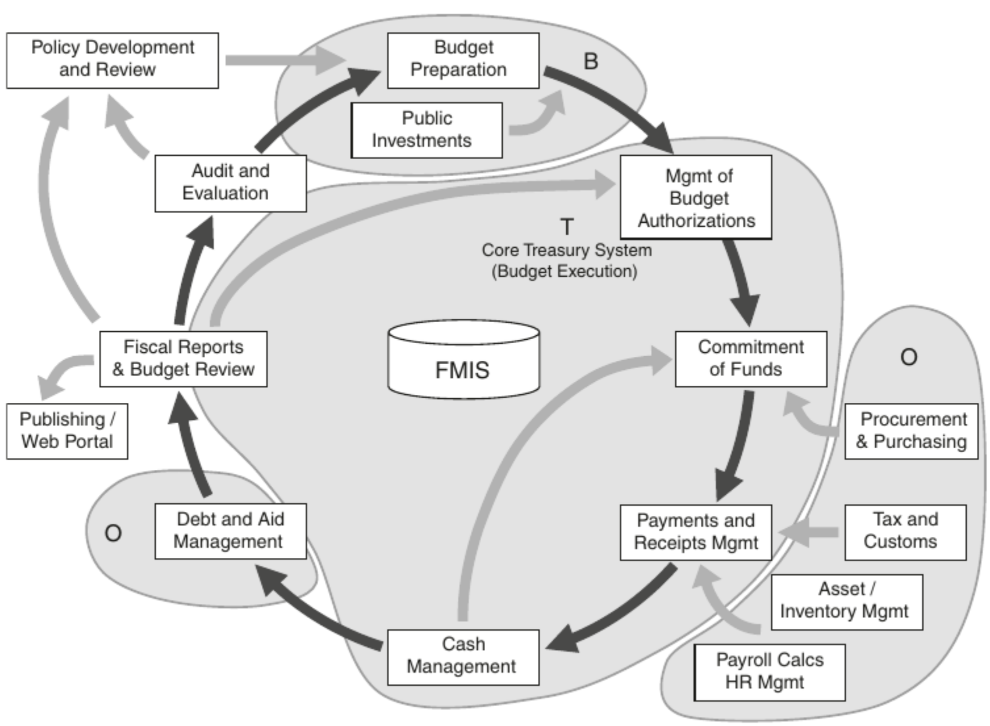


Figure 1 A modular Approach for building FMIS (source: World Bank (2011)

CHAPTER 28

Figure 1 shows a modular approach for building IFMIS. Generally, treasury (T) systems include budget execution, management of budget authorizations/releases and payments/revenue, commitment of funds, cash forecasting and management, accounting and reporting, accounts payable and receivable and the general ledger. Budget (B) systems include budget planning/formulation, medium-term expenditure frameworks, performance-related budgeting systems and public investment management. The non-core modules (O) sometimes linked with automated FMIS solutions are personnel management or payroll, revenue administrations (tax and customs), public procurement, inventory and property management, and performance management information.

It should be noted that the term "integrated FMIS" (IFMIS) is often used interchangeably with the term "FMIS," even when referring solely to automating the core budget execution and budget formulation processes. However, truly integrated FMIS solutions are rare in practice and entail a number of additional applications that extend beyond the scope of automating core financial management processes. Only when FMIS and other PFM information systems (e.g., procurement, asset management, revenue administration and payroll) share the same central database to record and report all financial transactions can they be referred to as an IFMIS. While the focus here is on FMIS, these more broadly based systems are partially addressed in other chapters.

1.8 Contextual and Technical Consideration of IFMIS

Contextual Consideration

Many factors like human resource management, political infrastructure should not be overlooked in designing and implementing an FMIS. The IT literacy and public finance training items noted in the following table are two specific examples of measures required to address these "soft" issues. Another important element is the need to train ministers and senior officials on the types of financial information they should expect to receive through the FMIS and how they can make best use of such data.

Table. Factors need to consider for automation

- o Automate existing chart of accounts, using automated bridge tables to link with budget classification.
- o Document accounting standards and procedures.
- o Document treasury and budget preparation procedures.
- o Develop awareness of basic PFM processes and procedures used by the finance staff and IT specialists who will be involved in the development of the FMIS.
- o IT literacy – Train potential users of the FMIS in the use of automated systems to enter information, generate reports and analyze data.
- o "Management" literacy – Train managers in the ministry of finance, line ministries and other agencies using FMIS in the benefits and uses of an automated financial management system, how to request information and how to use the reports and data generated as an input to decision making and improved accountability.

Source: World Bank (2011).

Technical Consideration

A number of technical issues should be addressed in implementing the IFMIS. Following Table presents the factors that are needed to consider.

Table. Technical factors need to consider for automation

o Explicitly address the expectations and incentives of all key stakeholders, and reach a consensus on the model to be adapted to smooth implementation.
o Assess areas in which PFM systems are performing poorly; evaluate the extent to which these problems can be addressed by automation or require a more thorough review of systems and business processes.
o If automation is deemed necessary to resolve PFM performance problems, keep the initial automation as simple and focused as possible, without too many supplemental or parallel reforms to distract from the main purpose.
o Pay attention to the needs of managerial and senior executive users for basic training in the use of automated information systems. Many senior officials grew up in a data-poor, manual system and will not be aware of the data that will become available in the new FMIS, what they should ask for and how to use the abundance of information.
o Pay attention to the incentives facing members of the FMIS project management team and their roles before assigning them to project team positions; minimize conflict of interests where they might occur.
o Assure adequate training for key ministry of finance and line ministry staff who will operate and use the new system to enable them to productively engage in the specification phases. Ensure that key officials have adequate time to participate in this early phase.
o Identify a senior official as the champion of the FMIS reform; he/she must understand the potential risks and barriers to reform internally and externally and be able to intervene to remove any issues or bottlenecks that arise. Hiring an international project advisor who has had experience with FMIS projects in other countries to provide advice on the implementation of the project can be useful, but the advisor should not be allowed to take over the leadership of the project.
o Approach the FMIS reform as a change management process; identifying potential areas of resistance as early as possible, proposing potential solutions and taking necessary steps to reduce or eliminate opposition by modifying attitudes and behavior will lead to improved performance.

Practice in Bangladesh: iBAS++

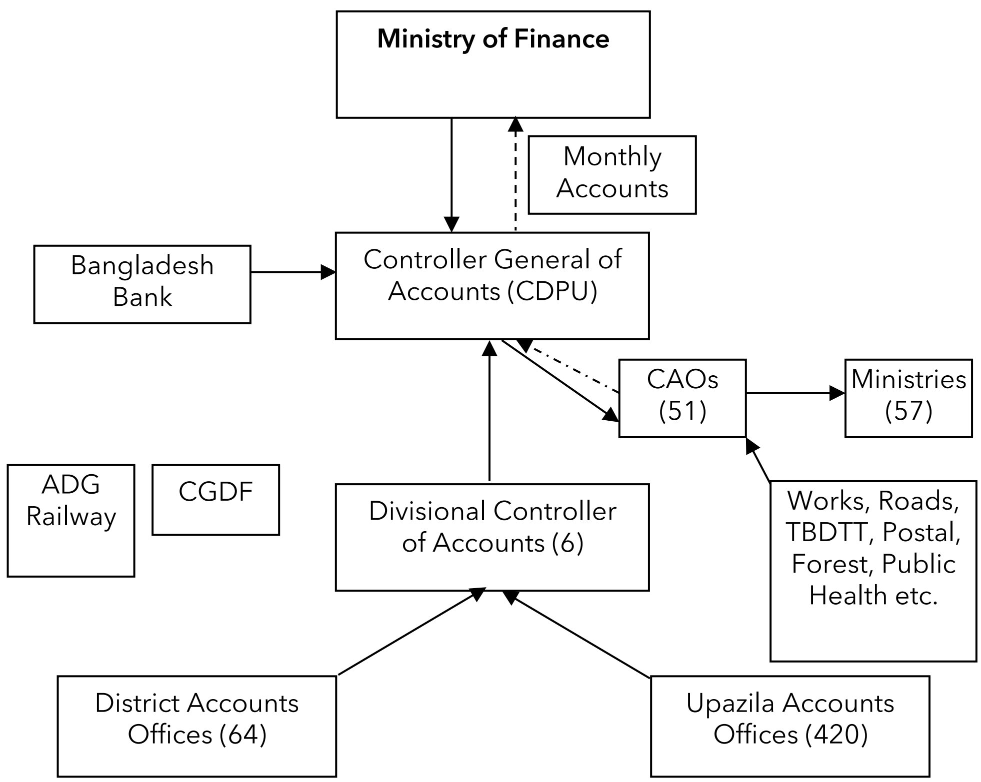
As a part of reformation of Public Financial Management (PFM), Bangladesh introduced Integrated Budget and Accounting Systems (iBAS). The iBAS is introduced under the Strengthening Public Expenditure Management (SPEMP) project, and still the iBAS is under the process of development. The SPEMP is funded by UK aid from Department of International Development (DfID), Danish International Development Agency (DANIDA), and European Union, and the project is administrated by the World Bank. The objectives of SPEMP are:

- o Strengthen and modernize core institutions of budgeting within the government with particular emphasis on introducing a performance orientation in public financial management o Enhance demand for better budget outcomes by improving the effectiveness of formal institutions of financial accountability, in particular Comptroller and Auditor General's Office and the financial oversight committee of the parliament.

Consisting with the objective of SPEMP, the iBAS is introduced in Bangladesh regarding the public finance management, especially focusing on the infrastructural strength of PSA. The iBAS was primarily considered as the modern replacement of TAS. Initially, iBAS was developed for simple transaction recording systems. During the development of the iBAS, authorities were aimed to add budget module in the same platform of accounting. However, because of traditional view, accounting and budgeting activities were maintained as separate activities.

Considering the limitation of the iBAS regarding the integration of budget and accounting, renovation of the software has taken place, and the renovation is continuing for further development. After the reformation, the iBAS++ has taken place of the iBAS. Integration between budget and accounting has given priority in reformation. Continuous assessment, monitoring, performance evaluation, and management are the concern of the iBAS++ to ensure the integration.

The flow of accounting data as well as the tasks of iBAS++ has been presented in the following figure.

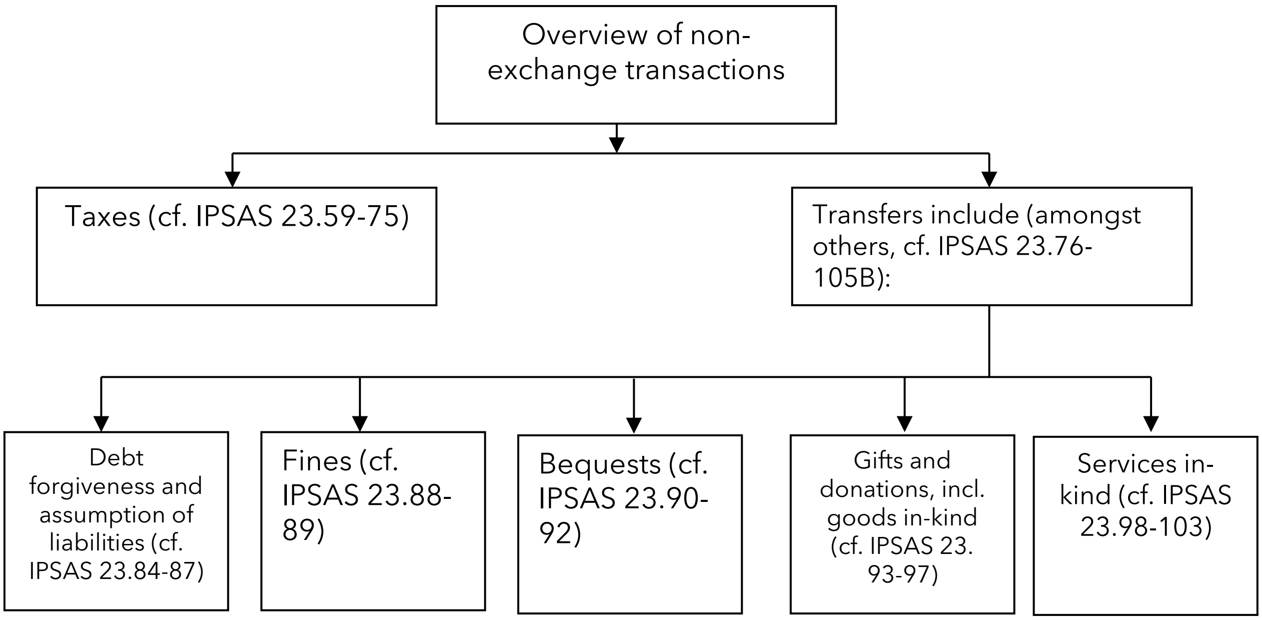


(Where, C&AG: Comptroller & Auditor General, CGDF: Controller and General Defense Finance; ADG: Additional Director General; CAO: Chief Accounts Officer and CDPU: Central Data Processing Unit. Note: Number of CAOs may vary regarding the number of ministries)

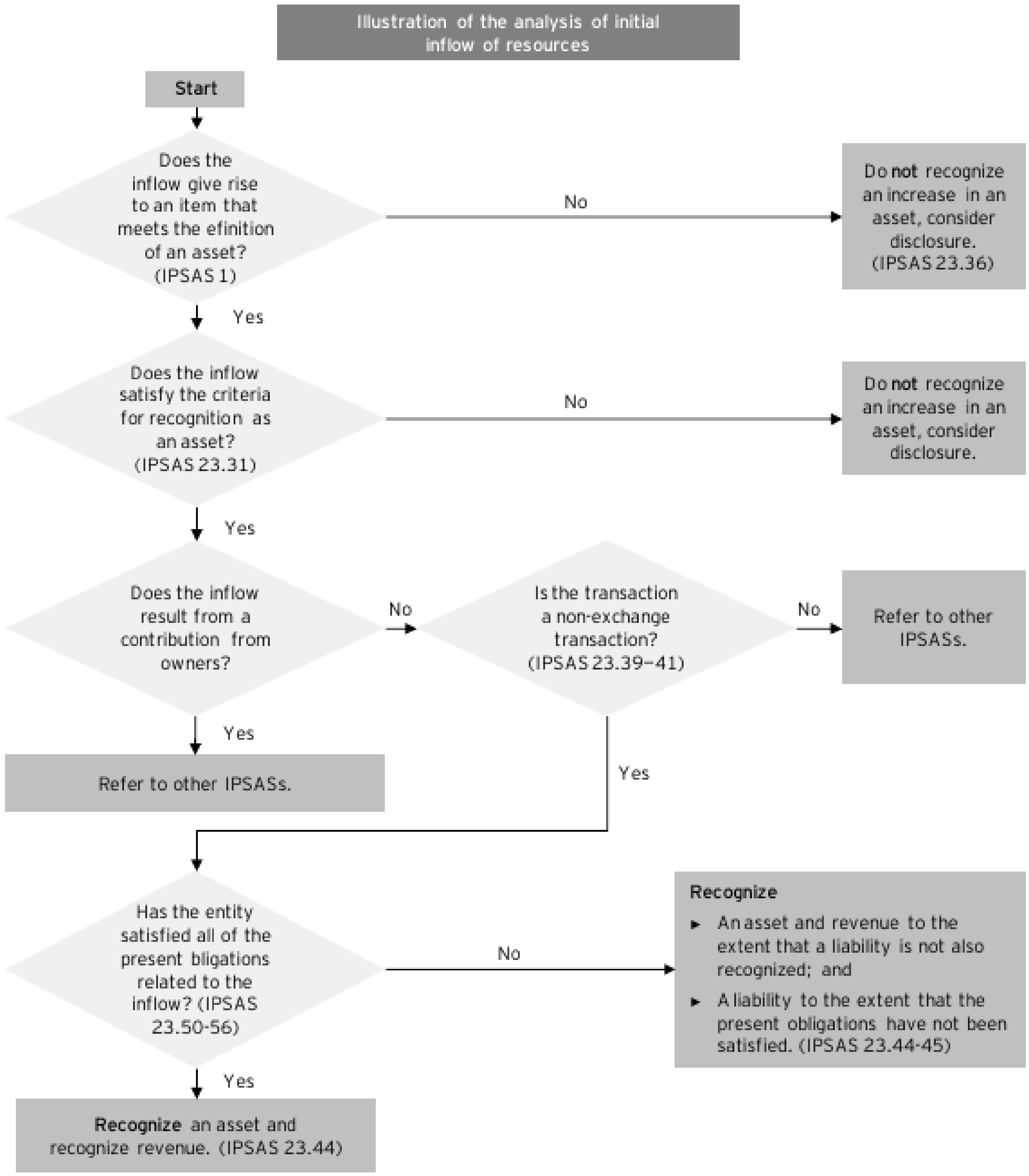
Fig. *Flow of accounting data in Bangladesh (Source: Various document of CGA)*

Summary

1) Overview of non-exchange transactions



2) Illustration of the analysis of initial inflows of resources



Source: International Federation of Accountants, Handbook of International Public Sector Accounting Pronouncements, 2011 Edition, Volume 1, p. 727

Self-test questions

1. A university has adopted the Cash Basis IPSAS. It prepares its statement of cash receipts and payments to a 31 December year-end. Its approved budget is prepared to a 30 November year-end and is published following approval by legislature. In this situation, what would the requirements of the IPSAS be, with regard to the presentation of a comparison of budget and actual amounts?

   a. A comparison of budget and actual amounts should not be made due to lack of comparability.

   b. The budget should be adjusted to a 31 December year-end and then a separate comparison of budget and actual amounts prepared on this basis.

   c. Additional columns for the budget figures should be added to the statement of cash receipts and payments.

   d. A separate statement of comparison of budget and actual amounts should be presented on the budget basis.

2. According to the Cash Basis IPSAS, in which two of the following circumstances would it be acceptable to change the presentation and classification of items in the statement of cash receipts and payments?

   i. As result of recently discovered procedural errors, an agency's finance director and director of IT have both been replaced and as a result, significant changes in operational procedures have been implemented.

   ii. A general hospital shuts down all of its adult wards in order to become a specialized regional children's hospital, resulting in a 70% reduction in revenues and expenses.

   iii. A university outsources the provision of student catering to a private sector company. Catering income previously accounted for 3% of the university's total revenue.

   iv. A municipal authority reviews its financial statements and concludes that a change will result in a more appropriate presentation of events or transactions.

      a. (i) and (iii)

      b. (ii) and (iv)

      c. (i) and (ii)

      d. (iii) and (iv)

3. Which two of the following statements are true in relation to the presentation of the statement of cash receipts and payments for a government department which has been applying the Cash Basis IPSAS for several years?

   i. Payments made on behalf of the entity by a non-governmental aid organisation should be separately disclosed as external assistance.

   ii. Comparative information should be disclosed in respect of the previous period for all numerical information.

   iii. Errors which relate to prior periods should be reported by adjusting the cash at the beginning of the period.

iv. Payments by third parties should be excluded unless they are part of the economic entity to which the reporting entity belongs.

a. (i) and (iii)

b. (ii) and (iii)

c. (i) and (iv)

d. (ii) and (iv)

4. A government department is preparing its financial statements for the year-ended 31 December 20X3 in accordance with the Cash Basis IPSAS.

The department sold property, plant and equipment during the financial year for total disposal proceeds of BDT120,000, giving a loss on disposal of BDT13,000. All of the disposal proceeds were received during the year and in addition, BDT44,000 relating to a disposal in the prior year was received at the beginning of 20X3.

Which of the following statements is true regarding how these transactions should be shown in the department's statement of cash receipts and payments for the year-ended 31 December 20X3?

a. The statement will include the total disposal proceeds received during the year of BDT164,000.

b. The statement will include only disposal proceeds of BDT120,000 received during the year.

c. The statement will net the BDT13,000 loss on disposal off against the disposal proceeds of BDT120,000.

d. The statement will include disposal proceeds of BDT120,000 received during the year, with the department having the option of disclosing the BDT44,000 disposal proceeds received in relation to the prior year in a note to the financial statements.

Answers to Interactive questions

Interactive Question 1.1: Control of cash

In (a) the state government does not have control of cash as all payments are made directly to the contractors by a third party, in this case the international charity. The amount paid on its behalf does not constitute 'cash' as defined in the Standard.

In (b) the state government has control of cash for the period that the cash is in its bank account. Once the cash is transferred the control will transfer. The cash balance is not available for use by the state government but is nevertheless controlled by it for the period in which the cash resides in its bank account per paragraph 1.2.7 of the Cash Basis IPSAS.

Interactive Question 1.2: Reporting cash flows on a net basis

(i) This does not meet the requirement for showing the cash flows net. The turnover of the two transactions was not quick (10 month delay during the legal battle).

(ii) This does meet the requirement for showing the cash flows net because the collection of patient prescription drug charges is merely administered by the hospital on behalf of the central Department of Health.

Interactive Question 1.3: Sub classifications in the statement of cash receipts and payments

Example solution for a hospital:

Total cash receipts may be classified to separately identified cash receipts from:

- Funding from central government
- Grants and donations
- Borrowings
- Proceeds from the disposal of property, plant and equipment
- Other on-going service delivery and trading activities (for example private patient income)

Total cash payments may be classified to separately identified cash payments in respect of:

- On-going service delivery activities
- Debt reduction programs
- Acquisitions of property, plant and equipment
- Any trading activities.

Note:

Your answer will vary, depending on the organisation that you selected.

Alternative presentations are also possible, for example total cash receipts may be classified by reference to their source and cash payments may be sub-classified by reference to either the nature of the payments or their function or program within the entity, as appropriate.

Interactive Question 1.4: Third party transactions

(a) In this case, the department does not control cash inflows, cash outflows and cash balances. However, the department benefits from the payments being made on its behalf, and knowledge of the amount of these payments is relevant to users in identifying the cash resources the government has applied to the department's activities during the period. The department reports in a separate column on the face of the statement of cash receipts and payments, the amount of payments made by the government on its behalf, and the sources and uses of the amount expended sub-classified on a basis appropriate for the department. These disclosures will enable users to identify the total amount of payments made, the purposes for which they were made and whether, for example, the payments were made from amounts allocated or appropriated from general revenue or from special purpose funds or other sources.

(b) The department reports in a separate column on the face of the statement of cash receipts and payments the amount, sources and uses of such expenditures made on its behalf during the reporting period. This will assist users in identifying the total cash resources of the economic entity which have been applied to the entity's activities during the reporting period, and the sources and uses of those cash resources.

(c) In this case, the government does not receive cash (including cash equivalents) directly from the international development agency. Therefore, the amount settled or paid on its behalf does not constitute "cash" as defined in this standard. However, the government benefits from the cash payments being made on its behalf. The government should report in a separate column on the face of its statement of cash receipts and payments, the amount, sources and uses of expenditures made by the third party (i.e. the international development agency) which is not part of the economic entity to which it belongs. This will enable users to identify the total cash resources being applied to the government's activities during the reporting period, and the extent to which those resources are provided from parties which are, and which are not, part of the government's reporting entity.

Interactive Question 1.5 Statement of cash receipts and payments (St Mary Hospital)

St Mary Hospital

Statement of cash receipts and payments for year ended 31 March 20X0

	Receipts/ payments controlled by the entity	Payments by third parties
	BDT'000	**BDT'000**
Receipts		
Funding allocations	9,560	1,300
Proceeds from borrowing	1,234	
Private patient and other income	1,958	
Proceeds from disposal of property, plant and equipment (35+210)	245	
Interest received	8	
Total receipts	**13,005**	**1,300**

Payments		
Wages, salaries and employee benefits	(10289)	
Medicines, supplies and consumables	(576)	(1300)
Utilities	(93)	
Purchase of property, plant and equipment	(1829)	
Repayment of borrowings	(98)	
Interest payments	(80)	
Total payments	**(12965)**	**(1300)**
Decrease in cash	**40**	
Cash at beginning of year	185	
Cash at end of year	**225**	

Interactive Question 1.6 Consistency

Paragraph 1.4.13 of the standard states that the presentation and classification of items in the financial statements should be retained from one period to the next unless a significant change in the nature of the operations of the entity or a review of its financial statements presentation demonstrates that the change will result in a more appropriate presentation of events or transactions. Therefore:

(a) meets the criteria for changing presentation and classification since the change will result in a more appropriate presentation.

(b) is a significant change in the nature of operations since the reorganisation involves losing responsibility for two major service lines which accounted for 70% of its revenues and expenses so this meets the criteria for a change in presentation/classification.

(c) does involve a change in operating activity but is not significant enough to justify a change in presentation or classification.

Interactive Question 1.7 Additional Exercise Cash and accruals bases of accounting

Advantages and disadvantages of accruals and cash bases of accounting

	Accruals basis	**Cash basis**
Advantages	The recognition of assets and liabilities improves the management of those elements	Simple and objective
	Provides information on the full cost of services which aids government policy and decision making and may assist improved economic performance	Useful for assessing compliance with cash budgets
	Focuses on retaining and upgrading assets, as well as spending, so examines a broader range of options for managing assets	Useful for monitoring and estimating a government's cash resources

	Accruals basis	Cash basis
	Assets may be revalued and are reviewed for impairments so that the quality of information is improved when making asset assessments	
	Revenues and expenses are recognised making performance measurement more reliable	
	Gives useful information about a government's level of liabilities	
Disadvantages	Technically complex and contains elements of subjectivity	Fails to show a full picture of financial position and performance
	Costly to implement – adequate accounting systems, training	Prevents decision makers from making future predictions
		Does not provide full total cost of services
		Focuses on spending on new assets rather than retaining or upgrading
		Unaware of true level of liabilities.

Interactive Question 1.8

The following receipts would constitute revenue for the year ended December 20X1:

d) - A donation from a local resident towards local services

The donation would constitute revenue; all the other receipts are matched by liabilities or increases in owner's equity.

The 20X2 property tax is an advance receipt.

The repayable receipt is probably a loan, except that a higher level public sector funding body might designate it as an equity interest, when it would be a contribution from owners.

The specific grant creates a present obligation and thus a liability.

Interactive Question 1.9 (Grant)

The university recognises the land as an asset in the statement of financial position of the reporting period in which it obtains control of that land. The land should be recognised at its fair value in accordance with IPSAS 17. The restriction does not meet the definition of a liability or satisfy the criteria for recognition as a liability. Therefore, the university recognises revenue in respect of the land in the statement of financial performance of the reporting period in which the land is recognised as an asset.

Interactive Question 1.10 (Donation)

The public hospital does not recognise any amount in its financial statements in respect of the pledges. The entity does not control the resources related to the pledge, because it cannot exclude or regulate the access of the prospective transferors to the economic benefits or service potential of the pledged resources; therefore it cannot recognise the asset or the related revenue until the donation is binding on the donor.

Interactive Question 1.11 (Classification of cash flows)

Cash outflows may be classified by nature of payments rather than by function.

The main headings that would be included in the statement using the nature basis are as follows:

- Wages and salaries
- Goods and services
- Utilities
- Subsidies and transfers
- Capital outlays
- Other.
- An organisation which is a recipient of external assistance

Interactive Question 1.12 Statement of comparison of budget and actual amounts (St Mary Hospital)

	Actual amounts (including 3rd party)	Final Budget	Original budget	Difference Actual-Final
	BDT'000	BDT'000	BDT'000	BDT'000
Receipts				
Funding allocations (Final=9,050+2.5%)*	10860	9276	9050	1584
Proceeds from borrowing	1234	1300	1300	(66)
Private patient and other income	1958	2150	2150	(192)
Proceeds from disposal of property, plant and equipment	245	57	57	188
Interest received	8	9	9	(1)
Total receipts	**14305**	**12792**	**12566**	**1513**
Payments				
Wages, salaries and employee benefits (Final=9,830+3%)	(10289)	(10125)	(9830)	(164)
Medicines, supplies and consumables	(1876)	(1700)	(1700)	(176)
Utilities	(93)	(95)	(95)	2
Purchase of property, plant and equipment	(1829)	(768)	(768)	(1061)
Repayment of borrowings	(98)	(89)	(89)	(9)
Interest payments	(80)	(42)	(42)	(38)
Total payments	**(14265)**	**(12819)**	**(12524)**	**(1446)**
Net Cash Flows	**40**	**(27)**	**42**	**67**

* Includes BDT1.3m third party payments

Interactive Question 1.13 (Financial Reporting Framework 2023)

As per financial reporting framework 2023 issued by FRC, Ministry of health will be an institution of Level 3. Therefore, following statements are required to prepare

1. Balance Sheet
2. Income Statement
3. Cash Flow Statement
4. Notes to the Financial Statements
5. Statement of Budget vs Actual

Answers to Self-test questions

1	D	According to paragraph 1.9.19 of the Cash Basis IPSAS, 'when the budget and financial statements are not prepared on a comparable basis, a separate statement of comparison of budget and actual amounts is presented...on the budget basis'. Option (a) is not permitted because the comparison is compulsory where the budget is published (paragraph 1.9.8). Option (b) is not permitted because the budget presented has been approved by legislature and hence the statement must present 'the budget amounts for which it is held publicly accountable' (paragraph 1.9.8). Option (c) is correct only where the budget and financial statements are prepared on a comparable basis (paragraph 1.9,8) , which they aren't in this scenario because of differing year ends.
2	B	The standard states that the presentation and classification of items in the financial statements should be retained from one period to the next unless there is a significant change in the nature of the operations of the entity or a review of its financial statements presentation demonstrates that the change will result in a more appropriate presentation of events or transactions. (i) involves a change in operating procedures but is not a significant change in the agency's operations so is not significant enough to justify a change in presentation or classification.. (ii) is a significant change in the nature of operations since the reorganisation involves losing responsibility for 75% of its transactions and changing its overall focus so this meets the criteria for a change in presentation/classification. (iii) is not a significant change in operations as only 3% of revenue/expenses are affected, and catering is unlikely to be a core activity for a university. (iv) meets the criteria for changing presentation and classification since the change will result in a more appropriate presentation.
3	B	(i) is incorrect because the payments have been made by a non-governmental organisation and so they do not meet the definition of official resources and hence are not external assistance. (ii) is correct per the standard. Don't get this confused with the requirement in relation to the comparison of budget and actual amounts, where prior year comparatives are not required. (iii) is correct per the standard. (iv) is incorrect because all third party payments are included in the statement, but they are disclosed separately between internal (i.e. part of the same economic entity) or external.

4	A	The standard states that transactions are only recognised when cash is received or paid by the entity. The BDT44,000 cash received in the current year in relation to the prior year disposal would not have been recognised in the prior year's statement and so must be recognised in the current year's statement, regardless of the fact that this cash receipt relates to the prior year. Therefore, the statement will include total cash receipts of BDT120,000 + BDT44,000 = BDT164,000. Note that the loss on disposal should not be included anywhere in the statement since this is an accruals based number and has no place in a statement of cash receipts and payments, although the department can choose to disclose accruals based information if it wishes.

Exercise

Comprehensive Exercise 1.1

The following trial balance was extracted from the accounting records of Junior Laboratory School as at 31 December 20X6:

	Debit (BDT)	Credit (BDT)
Sale of school uniforms and books		345000
Funding grants		1012000
Other operating expenses	255000	
Loan interest paid	2250	
Rental income		89000
Wages and salaries	847040	
Income from adult education courses (note 5)		205000
Capital contributed by government		275000
Sheds and Buildings – at valuation	450000	
Land - at valuation	200000	
Fixtures, fittings and equipment	567000	
Accumulated depreciation: buildings (at 1 Jan 20X6)		30000
Accumulated depreciation: fixtures, fittings and equipment (at 1 Jan 20X6)		250000
Provision (note 3)		38000
Bank	173400	
Current asset investments	30000	
Trade receivables and payables	38460	75150
Long term bank loan		110000
Retained earnings (at 1 Jan 20X6)		39000
Revaluation reserve		95000
	2563150	2563150

Additional Information

1. The National Languages Agency deposited BDT29,000 into the school's bank account on August 15, 20X6. This is included in the funding grants balance in the trial balance.

   The grant was given to the school with the requirement that it be utilized to hire a language teacher with specialized training in order to improve learning outcomes for pupils whose first language is not English. A suitably qualified teacher was employed for this project from 1 September 20X6, and the total salary cost for the teacher up to 31 December 20X6 was BDT8,000. Under the terms of the grant, the money can only be used as stipulated, and the school is required to include a note in its audited general purpose financial statements detailing how the grant money was spent. The agreement requires the grant to be spent as specified by 31 August 20X7 or be returned to the agency.

2. The school provides evening courses to adults in the local area, and these are fully funded by fees charged to adults. Of the total income of BDT205,000 shown in the trial balance, BDT106,000 relates to the September – December 20X6 term and the remainder relates to fees paid in advance for the January – April 20X7 term.

3. The school maintains land and buildings at their revalued worth per policy. During the year, an assessment of the land, sheds, and buildings showed that the land was worth BDT230,000 and the sheds and building were worth BDT475,000.

4. No depreciation charge has yet been accounted for.
   - The school's policy is to depreciate sheds & buildings straight line over their useful economic life of 60 years, of which 47 was remaining as at 1 January 20X6.
   - Equipment is depreciated using the reducing balance basis at 20% per year.

5. The provision relates to an on-going discrimination claim by a former teacher. Shortly before the end of the current financial year, the ex-teacher agreed to settle his claim in exchange for total compensation of BDT45,000 and a bank transfer for the full amount was made on 31 December 20X6, thus marking the end of the case. No entries have yet been made to the accounts.

6. During the year, a pupil was injured during a rugby match. The pupil's parents have begun legal proceedings, and the school's legal advisors believe that the school will eventually have to pay compensation of BDT500,000. Due to a backlog in the national courts system, the case is unlikely to be resolved in court until the end of 20X9. No amounts have yet been included in the trial balance.

Requirements:

(a) Explain, with reference to the relevant IPSAS, how items 5 and 6 above should be treated in the school's financial statements for the year-ended 31 December 20X6. [**Hint: IPSAS 9 or IAS 18**]

(b) Prepare the school's statement of financial performance for the year-ended 31 December 20X6 and the statement of financial position at that date.

Solution:

Item 5: Adult education fees

- The payment for the education courses has been made in the form of fees. Since this is an exchange transaction, IPSAS 9 Revenue from Exchange Transactions is the applicable accounting standard.

- Under IPSAS 9, tuition fees have to be recognised over the period of instruction. Therefore, only the BDT106,000 fees relating to course provided in 20X6 should be recognised and the amounts received in advance for 20X7 should be deferred until the following financial year.
- Therefore, BDT99,000 of the tuition fees must be excluded from tuition fee income and included within 'Income in advance' under current liabilities in the statement of financial position as at 31 December 20X6. In the 20X7 financial year, once the tuition has been provided, they can be released from the deferred revenue liability and recognised in income.

Item 6: Grant from National Languages Agency

- Unlike the adult education fees, which were received in direct exchanged for a service, this grant was not received in direct exchange for an asset or service of the same value. It is a non-exchange transaction and therefore the relevant accounting standard is IPSAS 23 Revenue from Non-Exchange Transactions (Taxes and Transfers).
- Upon receipt, the school would have recognised the entire grant as a liability as it has conditions attached. As the school satisfies the condition, that is, as it makes authorized expenditures, it reduces the liability and recognises revenue in the statement of financial performance of the reporting period in which the liability is discharged. Therefore, BDT8,000 of the grant can be recognised in revenue for the year to 31 December 20X6 and the rest (BDT21,000) will be included in current liabilities. As all of the grant is currently included within grant income, grant income will need to be reduced by BDT21,000. In the following financial year, assuming that the teacher remains in employment providing the services stipulated by the grant, the remainder of the grant income can be recognised.

(a) Statement of financial performance for Junior Laboratory School for the year-ended 31 December 20X6

	Workings	
Operating Revenue		BDT
Funding grants	1,012,000-21,000 (a)	991000
Rental income		89000
Tuition fees	205,000 – 99,000 (a)	106000
Other revenue		345000
Total operating revenue		1,531,000
Operating expenses:		
Wages, salaries and employee benefits		(847040)
Depreciation	10,106+63,400(W2)	(73506)
Legal claims	7,000 + 500,000 (W3)	(507000)
Other operating expenses	255,000	(255000)
Total operating expenses		(1682546)
Surplus/(deficit) from operating activities		(151546)
Finance costs		(2250)
Surplus (deficit) for the yea		(153796)

Statement of financial position for Junior Laboratory School as at 31 December 20X6

	Workings	BDT'000
ASSETS		
Current assets		
Receivables		38,460
Short term investments	173,400 + 45,000 (note 3)	30,000
Cash		128,400
		196,860
Non-current assets		
Land	W1	230,000
Sheds and Buildings	W1	464,894
Equipment	W1	253,600
		948,494
Total assets		**1,145,354**
LIABILITIES		
Current liabilities		
Payables		75,150
Provision for legal claim		500,000
Income in advance	99,000 + 21,000	120,000
		695,150
Non-current liabilities		
Bank loan		110,000
Total liabilities		**805,150**
Net assets		**340,204**
NET ASSETS/EQUITY		
Capital contributed by government		275,000
Revaluation reserve	95,000 + 30,000 + 55,000 (W1)	180,000
Accumulated deficit	39,000 – 155,796	-114,796
Total net assets/equity		**340,204**

Working 1: Property, plant and equipment

	Land	Sheds and Buildings	Furniture, fittings and equipment
	BDT	BDT	BDT
Cost or valuation			
b/f	200,000	450,000	567,000
Revaluation (balancing figure)	30,000	25,000	
c/f	230,000	475,000	567,000
Accumulated depreciation			
c/f		30,000	250,000
Revaluation		-30,000	
Charge for the year (W2)		10,106	63,400
c/f	-	10106	313400
Carrying value at year-end	**230,000**	**464,894**	**253,600**
Revaluation of building:	**Before**	**After**	**Movement**
	BDT	BDT	BDT
Gross cost	450,000	475,000	25,000
Accumulated depreciation	-30,000	-	30,000
Net carrying value	**420,000**	**475,000**	**55,000**
			– to revaluation reserve

Working 2: Depreciation

Sheds and Buildings: BDT475,000/47 =	10,106
Equipment: (BDT567,000-BDT250,000) x 20%	63,400
	73,506

Technical References

1	Cash Basis IPSAS	IFAC
2	Transition to the Accrual Basis of Accounting: Guidance for Public Sector Entities	IFAC
3	International Public Sector Accounting Standards	IFAC
4	Financial Reporting Framework 2023	Financial Reporting Council (FRC), Bangladesh

Chapter 29

Audit Standards and Practices in the Public Sector

Topic

2.1 Legal framework of public sector auditing
2.2 Types of Public Sector Auditing
2.3 Internal Control and Internal Auditing
2.4 External Control and Practices
2.5 Public Sector Auditing Standard and practices
2.6 INTOSAI and related materials

Learning outcomes

It is expected that after completing the chapter students will be able -

- Understand the legal framework of public sector auditing
- Specify the types of public sector audit
- Narrate the internal control process and auditing
- Narrate the external control process and auditing
- Explain the public sector auditing standard and practices
- Demonstrate the application of INTOSAI.

Syllabus Links

The material in this chapter is linked to the previous course in the Certificate Level module of Accounting.

Examination Context

Questions on topics in this chapter will be descriptive and conceptual/mathematical. In the exam you may be required to:

- State the legal framework of public sector auditing
- Explain the types of public sector audit.
- Explain the internal control process and audit
- Explain the external control process and audit
- Use the international standards for public sector audit.

1 Chapter overview

- Auditors provide independent assurance to principals about the activities of their agents.
- There are international standards for conducting the external audits in the public sector. The standards focus on the area, plan and scope of audit work, evidence collection procedures, sampling and analyzing process, independence of the auditor and audit reports.
- PBE auditors are more concerned with other things than whether the financial statements accurately depict the PBE's financial situation. They are likely to have more regard to issues of fraud, waste and extravagance and to give an opinion on value for money.

2.1 Legal Framework of Public Sector Auditing

The Supreme Audit Institution (SAI) is the authority of a country for Public sector auditing. SAIs are national bodies responsible for the independent audit of government revenue and expenditures. In most countries the SAI has a close relationship with but remains independent of the legislature. In general terms the SAI's role is to provide an objective report to the public and the legislature on the legal and proper management of the public finances. The International Organization of Supreme Audit Institutions (INTOSAI), which is the recognized international body representing most SAIs, describes the management of public finances as a trust held by elected officials (who are thus accountable to the public for the exercise of this trust) and external audit as part of a regulatory system whose aim is to reveal deviations from accepted standards of legality, economy, efficiency and effectiveness of financial management (INTOSAI 1977). However the scope of external audit work will vary depending on the legal mandate of the external auditor. The role of the SAI may be prescribed in the constitution or in legislation – in the latter case either in a public finance law or in a separate law on external audit. The legislative trend in recent years has been to develop separate audit legislation.

2.2 Types of Audit and Practices

In General, public sector auditing can be categorized in two forms.

- Internal Auditing
- External Auditing

External and internal auditors can each be involved in regularity, performance and compliance audits. The major forms and the types are explained below;

2.2.1 Forms/structure of Auditing

1) Internal Auditing:

Internal audit (IA) is an integral part of internal management controls. It can be viewed as a managerial control that functions by reviewing, evaluating and making recommendations for improving the effectiveness of the other controls. Its role is twofold.

- First, it exists to provide the head of a government entity (whether a ministry, department or agency) with an objective and independent opinion on the soundness of the internal operations of the institution.
- Second, its findings and recommendations should provide an input to management in taking corrective action to improve the effectiveness of the organization's operations.

International Standards for the Professional Practice of Internal Auditing

The Institute of Internal Auditors (IIA) issues International Standards for the Professional Practice of Internal Auditing. The underlying principles in internal auditing are generally similar to those for external auditing. Internal auditors should act diligently, professionally and with integrity at all times. Internal auditors should protect their actual and perceived objectivity and independence and take steps to avoid or remove any actual or perceived conflicts of interest.

2) External Auditing

The Supreme Audit Institution is responsible for external audit of governmental institutions. In this general sense external auditors can reasonably be described as guardians of the public interest, preventing or at least reporting on any misuse of public funds by the government. A well-functioning external audit institution has strong public credibility based on its independence and professional skills and the quality and relevance of its reports. External auditors have a uniquely broad overview of the operation of the PFM system, starting in some cases with budget development and approval and continuing through budget implementation and reporting. They have an important potential role as a catalyst to stimulate PFM reforms by appropriate evaluation and reporting on the operation of the PFM system and commenting on proposals by the government to modify the system of accounting and financial reporting. However SAI reporting arrangements and effectiveness also vary, reflecting both different administrative traditions and different legal frameworks.

The importance of the external audit component of the PFM system is reflected in the work of international development partners (the World Bank, the regional development banks, the IMF and bilateral aid agencies) in encouraging the development of external audit in developing and middle-income countries as part of overall improvement of their PFM system and in providing assistance in building capacity. In many such countries, lack of an adequate legal framework, inadequately transparent financial reporting by the government, and weak accounting and auditing capacity are likely to result in weak SAIs and therefore limited accountability for the management of public funds.

Major characteristics of External Audit

Detection of fraud and corruption:

As with private sector financial auditing, under auditing standards financial and compliance auditing does not have detection of fraud as its prime objective – even though the SAI may have a prosecutorial role in the case of identified financial improprieties. However, fraud may be detected or discouraged by the work of a sound SAI in reinforcing the legal and institutional arrangements of the country's PFM system. In this sense there may be an expectation gap: auditors sometimes describe themselves as a "watchdog" rather than a "bloodhound." In many countries separate public sector agencies (for example, a financial inspectorate) have a specific mandate to detect and prevent fraud and corruption.

Systems-based auditing:

It should be understood that modern financial and compliance auditing does not (and indeed cannot) check every transaction. Rather, a systems-based approach is used, under which control systems are reviewed and, based on perceived levels of risk arising from gaps or deficiencies in the system, particular transaction or types of transactions are selected for review.

Ancillary roles:

In some countries SAIs may have additional roles. For example, both the German and Russian SAIs assist the legislature in its review of the executive's proposed budget and, until the Office for Budget Responsibility was established in 2011, the U.K. National Audit Office reviewed and commented on economic and other assumptions used by the government in preparing the annual budget.

Reporting to the executive branch:

It needs to be recognized that the executive as well as the legislature potentially has a vital interest in the work of the SAI and can use it constructively in improving the PFM system. Thus, in some countries there is provision for the SAI to report both to the legislature and to the executive (head of state and/or prime minister). Indeed, in countries with a weak legislative tradition and authoritarian executive government, this may enhance the impact of the SAI's work since it is directed at the main source of decision making, although it may also be regarded as reducing the SAI's independence from the process of decision making by the executive.

Pre-audit

The desirability of SAIs having a pre-audit role (that is, approving financial transactions before they are entered into) as well as a post-audit role (reviewing transactions after the event) is a debated issue. INTOSAI, while commenting that pre-audit is indispensible to sound public financial management and that some SAIs have this role, notes that this role may be carried out by other institutions.

Contracting out

In some countries, because of shortage of qualified auditors or as a matter of policy to provide contestability of audit services, the SAI may contract some of its work to private sector auditors, who may sign audit reports on behalf of the SAI. The auditing of sub-national government and of government businesses such as government agencies and state-owned enterprises are often contracted out. The SAI nevertheless remains responsible for the audit and must have appropriate quality-control mechanisms to govern this work.

Audit opinions in External Auditing

External auditors are required to give an opinion on the financial statements they have audited. An auditor's opinion can be either unmodified or modified. An unmodified opinion means 'the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework is often referred to as a clean audit opinion'.

The external auditor's objective relates to the absence of material errors or mistakes so the level of materiality is crucial to the auditor's opinion. The level of materiality affects both the amount of work that the auditor has to undertake to be confident about their opinion and the usefulness of the financial statements to the user.

The exact wording of opinions differ across countries. ISA 700 allows the opinion either to be whether the financial statements present fairly or give a true and fair view of the organization's finances. In this context:

- **true** means that information is factual and conforms with reality, conforms with required standards and law and the financial statements are based on data that has been correctly extracted from the financial systems; and
- **fair** means that information is free from discrimination and bias and reflects the substance of the organization's underlying transactions.

A modified opinion means that the auditor cannot affirm that the financial statements are true and fair.

There are three types of modified audit opinions according to ISA 705 Modification to the Opinion in the Independent Auditor's Report (IAASB, 804):

- qualified (either on the basis of misstatement or on the basis of an inability to obtain sufficient, appropriate audit evidence);
- adverse; and
- disclaimer.

A qualified opinion is given when the auditor concludes that the financial statements are materially misstated. This could be because they conclude the level of monetary error in a balance was material or that the organization had failed to apply an accounting standard correctly.

Where the auditor is unable to obtain sufficient appropriate audit evidence on which to base their opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, then they would issue a qualified opinion. In this situation the auditor would explain the circumstances of the limitation on the scope of their audit in the basis of their opinion

An adverse opinion is given when the auditor has obtained and evaluated sufficient audit evidence and 'concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements' (International Auditing and Assurance Standards Board (IAASB), 2020: 806).

The auditor shall disclaim an opinion when they are unable to obtain sufficient appropriate audit evidence on which to base an opinion and concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

External audit of public sector organizations

The external audit of a PBE might differ from the audit of a private sector organization in a number of ways. For a PBE the auditor may:

- be required to give an opinion about lawfulness of expenditure (and may have the power to declare items of expenditure as unlawful);
- place a greater emphasis on fraud and corruption (such as by carrying-out data-matching to detect frauds);
- place a greater emphasis on the value for money achieved by the organization;
- carry out audit checks on grants, on behalf of the grant givers;
- conduct special investigations; and
- may be obliged to answer questions and consider objections from members of the public about the financial statements being audited.

It is crucial that the users of accounts can rely on the opinions that auditors give and this requires the auditor to be independent of the organization that they are auditing. One particular instance where independence is critical is the audit of government itself. In that situation the auditor needs to have independence from the politicians and government that they are charged with auditing.

> Interactive Question 2.1
>
> When carrying out an audit, what are some warning signs that may cause an external auditor to suspect there could be fraud or irregularities in the financial statements?
>
> See **Answer** at the end of this chapter.

2.2.2 Types of Auditing

i) Regularity auditing

Regularity auditing is what is seen as the traditional focus of auditing. A regularity audit is focused on financial statements or processes and the purpose is to reach an opinion about whether the statements or processes are 'regular' in the sense that they conform with appropriate standards and conventions. Regularity auditing is sometimes referred to as financial auditing because of its focus on financial statements, or as statutory auditing, because it is the type of audit that public and private sector organizations are legally required to have in respect of their published financial statements.

Scopes of Financial audits are given below:

Table: Scope of Financial Audit

o budget preparation in accordance with instructions of the executive; o acceptable estimates; o budget structure in compliance with the law; o budget process in compliance with the law; o architecture of budget accounting system; o accounting systems and internal control; o safety, continuity, and verifiability of the budget system; o safety, continuity, and verifiability of systems in general; o efficiency of the budget system; o efficiency of systems in general; o effective budget control; o supervision structure;	o feedback systems; o timely updating of budgets; o accurate and complete collection of taxes; o feasibility and verifiability of new laws and regulations; o acceptability of commitments; o acceptability of contracts; o structure of the accounting system; o timeliness of accounting transactions; o registration of performance information; o materials management; o inventories; o efficient risk management; and o frequent screening of risk indicators.

Regularity audit is linked to the concept of stewardship. Arguably any person who is charged with using public money for some purpose (i.e., any public manager) has a responsibility to take care of it (to steward the money), but it would particularly be seen as the responsibility of the chief finance officer or treasurer of a Public benefit entity (PBE). The latter is required to produce a set of financial statements that demonstrate, inter alia, the stewardship of public money and those financial statements are subject to audit, to provide assurance to third parties that the financial statements are complete and accurate.

Regularity auditing is clearly relevant to external auditors as described earlier but internal auditors can carry out regularity audits. For example, an internal auditor might carry out an audit of the accounts payable computer system with the emphasis to ensure that all the payments made are correct and valid and the subsequent accounting entries are complete and accurate. . In fact, internal audit may undertake just this sort of regularity audit work in a coordinated programme with the external auditors so that the two auditors' resources are used most efficiently (i.e., effort is not duplicated) and there is less disruption to the organization's finance staff and managers.

Interactive Question 2.2

The external auditor of a public benefit entity (PBE) is auditing the income for the year. The level of materiality is set at BDT1 million. The total income is BDT50 million. Within this total, there was BDT47.5 million of government grants. All those grant claims and receipts have been checked and verified. Does the auditor need more evidence to be assured of the income figure?

See **Answer** at the end of this chapter.

ii) Performance Auditing

Performance Auditing (PA) has been defined in various ways. Though there are variations in definition, it is common that PA will assess the performance of an entity whether tools may vary. National audit offices of countries across the world as well as the Supreme audit institution have defined the PA in various ways also. Whatever be, it is accepted that activities and results are the concern of performance auditing rather than reports or accounts (INTOSAI, 2019). INTOSAI (2019) asserts that performance audits contribute to transparency and accountability.

Following the opinions of the scholars and National audit offices of countries across the world, the contents of PA have changed over the years. The International Organization of Supreme Audit Institutions (INTOSAI) also has issued the guidelines for the contents along with the principles of PA.

Traditionally, PA focuses on the economy, efficiency and effectiveness of organizational and internal activities. These are often terms as three elements of PA **o**r 3Es. The International Standards of Supreme Audit Institutions (ISSAI) published by INTOSAI indicate the 3Es for the performance auditing. As per the ISSAI 300, Economy, Efficiency and Effectiveness are the premises of performance auditing. *The economy* emphasizes minimizing the costs of resources. Maintaining timeliness, appropriate quantity and quality at the best price can minimize the cost of resources. *Efficiency* is related to the output and the amount of input that has been used. Efficiency emphasizes maximizing the output by using the available resources regarding timeliness, quantity and quality. *Effectiveness* concerns the objective and attaining the intended results.

Interactive Question 2.3

If you were carrying out a performance audit of a service or project you are familiar with, what would be the main areas that you would examine? How easy or difficult would it be to measure the effectiveness of the service or project?

See **Answer** at the end of this chapter.

iii) Compliance Audit

A compliance audit is about reviewing and checking whether an organization is carrying out a particular activity or function in line with the relevant laws or regulations. Different approaches to compliance audit can be taken depending on the organization and focus of the audit. In most cases, a specially trained auditor is assigned to work through a checklist, thus ensuring that all requirements are met, and nothing falls short of the relevant regulations.

Compliance auditing is very important in some sectors, particularly where regulations are complex and changing, such as financial services like banking and insurance. Compliance auditing is also particularly relevant where an organization needs to be accredited to carry out certain activities, such as forensic science laboratories. In these organizations the compliance audit provides assurance that they can be accredited and can continue in that activity or business.

2.2.3 Relationship between External and Internal Audit

Developing an effective working relationship between the bodies responsible for internal and external audit is important. Internal audit may carry out the same forms of audit as external audit (compliance, financial and performance audits) and use the same standards and methodologies but reports to top management in the executive as its "eyes and ears." As such, internal audit is a key component of the overall internal control system. Auditing standards stress that external audit should have access to and use internal audit reports as part of its work. In practice, in many countries internal audit focuses on compliance auditing rather than financial or performance auditing.

Institutional arrangements for internal audit may vary significantly among countries. In some countries each ministry and government agency has its own internal audit unit, which reports to its top management. The heads of these units in some countries may be titled inspector-generals. In other cases there may be a central internal auditing bureau located in the ministry of finance and serving its control needs as well as or instead of the top management of individual administrative units. Such a unit may be located in the office of the prime minister or the president. In some countries central units have a strong tradition of ex-ante audit. In other countries both such institutions – a central unit based in the Ministry of Finance and the audit units in individual ministries and agencies – may coexist.

Interactive Question 2.4

Why is the internal audit code of ethics based on principles rather than rules?

See **Answer** at the end of this chapter.

Practices in Bangladesh

Office of the Comptroller and Auditor General of Bangladesh (OCAG) is the Supreme Audit Institutions (SAI) in Bangladesh. The OCAG is mandated by Article 128(1) of the Constitution of the People's Republic of Bangladesh. The OCAG is an independent audit oversight body and is known as an important pillar of the National Integrity Systems (NIS). The OCAG is responsible for auditing the receipts and expenditures of governments and give opinions on whether the money is duly accounted for under the rules and regulations of the Bangladesh government. According to section 5(1) of OCAG (Additional Functions) Act 1974, OCAG is authorized to audit the statutory public authorities, public enterprises and local governments as well.

There are 17 audit directories at OCAG. They are Civil Audit Directorate, Revenue Audit Directorate, Commercial Audit Directorate, Works Audit Directorate, Transport Audit Directorate, Foreign Aided Projects Audit Directorate, Posts, Telecommunication, Science, Information, And Technology Audit Directorate, Defense Audit Directorate, Health Audit Directorate, Education Audit Directorate, Agriculture and Environmental Audit Directorate, Local Government and Rural Development Audit Directorate, Social Security Audit Directorate, Power and Energy Audit Directorate, IT and Public Services Audit Directorate, Constitutional Bodies Audit Directorate and Mission Audit Directorate.

According to the constitution, parliament has the power to control the finances through approving the budget and assessing the audit reports. The Public Accounts Committee (PAC) which is established from the constitutional provision assesses the audit reports on public accounts. Therefore PAC plays an instrumental role on behalf of the parliament to ensure accountability.

The OCAG provides the audit reports on the accounts which are assessed by the PAC to reveal whether the funds approved by the parliament have been used for the target purpose and whether the expenditures have been incurred as per the authority and responsibility.

There are four types of public sector auditing in Bangladesh. They are -

1) Compliance Audit
2) Performance Audit
3) Special Case Audit
4) Financial Audit

2.3 Auditing Standard and Practices

Pronouncements and standards of external audit come from a variety of sources – two international professional organizations (INTOSAI and the International Federation of Accountants, IFAC), IFIs and the donor community and the NGO sector. Such standards are generally consistent but illustrate some difference in approach. For example as discussed below, professional standards set by INTOSAI are principles-based, whereas those developed by IFAC tend to be more rule-based. Accepted standards for external auditing are discussed below –

INTOSAI

Nearly all SAIs are members of INTOSAI, which now has some 190 member countries. As a professional body INTOSAI issues declarations, standards, guidelines and best practice statements to govern and strengthen the operations of SAIs, although it has no formal powers of enforcement. The two most significant declarations are the 1977 Lima Declaration on the Guidelines on Auditing Precepts and the 2007 Mexico Declaration on SAI Independence. The Lima Declaration covers several issues: the independence of SAIs; their relationship with the legislature and the government; their mandate and audit powers; audit methods, audit staff and international exchanges of experience; and reporting by SAIs. The Mexico Declaration sets out eight principles or pillars of SAI independence, which are discussed below. The 2010 INTOSAI Congress adopted international standards of supreme audit institutions (ISSAI). INTOSAI has also issued Guidance for Good Governance. These INTOSAI statements have wide authority and acceptance internationally, not just with SAIs but with national authorities responsible for PFM and with development partners. However, they may not always be reflected in the legal and operating frame-work established for a particular country's SAI. As a professional body INTOSAI also studies emerging issues (such as the SAI's role in program evaluation, anti-money-laundering activities and the development of "national indicators" which aim to measure "national well-being") and makes good-practice recommendations.

Apart from ISSAI, there are some other standards issued by development partners and International Financial Institutions (IFIs). These are discussed below –

PEFA assessment of SAIs

The PEFA PFM performance assessment tool (www.pefa.org) is now generally accepted as the international standard in assessing the quality of a country's PFM system. The 28 general indicators contain two on external audit and one related indicator on timelines for the preparation of financial statements. The first indicator covers the scope, nature and follow-up of external audit reports and notes. The second PEFA indicator examines legislative scrutiny of external audit reports.

IMF Code of Fiscal Transparency

The IMF manual (manual on fiscal transparency) states that an SAI, which is independent of the executive, should provide timely reports for the legislature and public on the financial integrity of government accounts. It notes that their essential function is to uphold and promote public accountability. It states that it is important that the SAI report directly to the legislature and that there should be a presumption that reports are publicly available once submitted to the legislature. The manual also stresses the importance of remedial action in response to adverse audit findings and that the executive branch should not be able to make the SAI ineffective by denying it adequate funding, controlling its staffing or delaying consideration of its reports. It considers that standards of external audit practice should be consistent with international standards, such as those issued by INTOSAI.

International Federation of Accountants (IFAC)

IFAC is an international professional body bringing together accounting and auditing organizations of 129 countries, both developed and developing, to achieve international harmonization and to improve accounting and auditing practices. IFAC has no formal powers to enforce adherence to its standards, and many countries have their own national standards – which may not be fully consistent with the international standards. However, member organizations are required to use their "best endeavors" to achieve adherence to international standards. The issue of international standards and guidance on good practices is a key component of IFAC's work, in which two main subsidiary bodies are involved. First, the International Auditing and Assurance Standards Board (IAASB) has issued some 36 international standards on auditing (ISAs) and one international standard on quality control (ISQC). While these professional auditing standards are considered generally applicable to government auditing, separate INTOSAI standards provide some clarification and modification to reflect the government environment. These auditing standards cover issues such as audit planning, quality control, assessing materiality and risk, assessing evidence, analytical work and audit sampling. Many countries have their own national auditing standards, which may differ from the international standards, and work on the convergence of national with international standards is ongoing. Second, the International Public Sector Accounting Standards Board (IPASB) has issued over 50 professional standards and pronouncements to govern financial reporting by governments and their component bodies, which are significant in terms of the SAIs role in auditing government financial statements. As with auditing standards, many countries have their own national standards for government financial reporting, and so the harmonization of national with international standards is a developing issue.

Practice in Bangladesh

The Office of the Comptroller and Auditor General of Bangladesh has taken INTOSAI and their standards for public sector auditing.

Interactive Question 2.5

Suppose you have been hired by the Office of the Comptroller and Auditor General of Bangladesh (OCAG) to conduct financial audit of ministry of education.

Requirement

Mention the standard you would like to follow to conduct the audit.

See **Answer** at the end of this chapter.

2.4 INTOSAI Framework of Professional Pronouncements (IFPP)

INTOSAI Professional Pronouncements are the formal and authoritative announcements or declarations of the INTOSAI Community. They draw on the collective professional expertise of INTOSAI's members and provide INTOSAI's official statements on audit-related matters. All the pronouncements are organized and numbered according to their status and purpose in a single framework.

This framework –The INTOSAI Framework of Professional Pronouncements (IFPP) – contains three categories of professional pronouncements:

2.4.1 The INTOSAI Principles (INTOSAI-P)

The INTOSAI Principles consist of founding principles and core principles. The founding principles have historical significance and specify the role and functions, which SAIs should aspire to. These principles may be informative to Governments and Parliaments, as well as SAIs and the wider public and may be used as reference in establishing national mandates for SAIs.

The core principles support the founding principles for an SAI, clarifying the SAI's role in society as well as high level prerequisites for its proper functioning and professional conduct.

2.4.2 International standards of supreme audit institutions (ISSAI)

The ISSAIs are the authoritative international standards on public sector auditing. The ISSAIs are comprised of:

- The basic set of concepts and principles that define public sector auditing and the different types of engagements supported by the ISSAIs.
- The fundamental principles which INTOSAI have defined as universally applicable professional standards. The auditing practices of all SAIs as well as any national standards for public sector auditing should be aligned to these.
- The organizational level requirements which the SAI and the engagement level requirements which the auditor must comply with if they state compliance with the ISSAIs (rather than national standards)
- Application material that is relevant to ensure that the fundamental principles and requirements are understood and applied as relevant in the circumstances of the individual engagement.

The purpose of the ISSAIs is to:

- Ensure the quality of the audits conducted.
- Strengthen the credibility of the audit reports for users
- Enhance transparency of the audit process
- Specify the auditor's responsibility in relation to the other parties involved.
- Define the different types of audit engagements and the related set of concepts that
- Provides a common language for public sector auditing.

ISSAI 100 'The Fundamental Principles of Public Sector Auditing' operationalizes the INTOSAI principles into standards at both the organizational level and at the engagement level. ISSAI 100 defines the authority of the ISSAIs and defines how an auditor can claim ISSAI compliance in an audit report.

Interactive Question 2.6

What are the objectives of ISSAI?

See **Answer** at the end of this chapter.

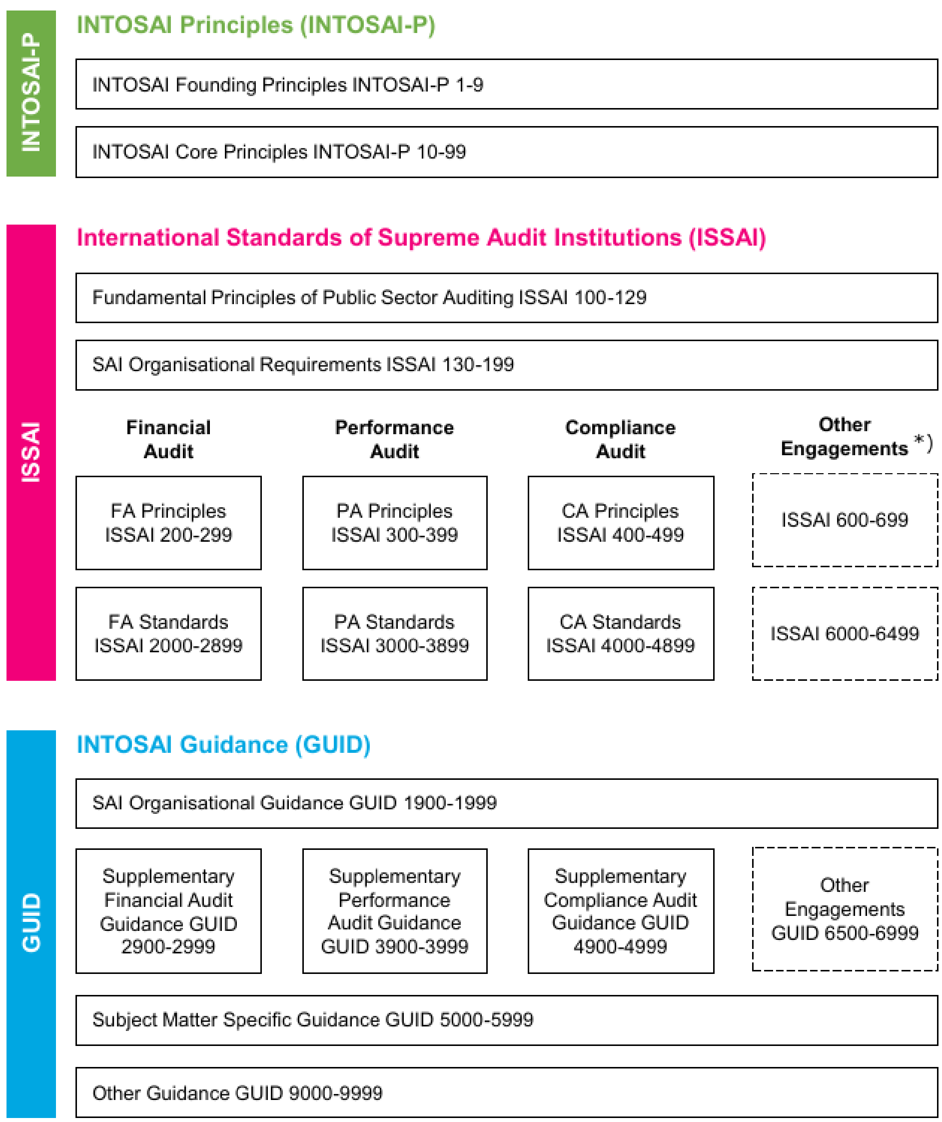
2.4.3 The INTOSAI Guidance (GUID)

The guidance is developed by INTOSAI in order to support the SAI and individual auditors in:

- How to apply the ISSAIs in practice in the financial, performance or compliance audit processes
- How to apply the ISSAIs in practice in other engagements
- Understanding a specific subject matter and the application of the relevant ISSAIs

The INTOSAI framework of professional announcement can be presented by figure. The figure is given below -

Figure - The INTOSAI Framework of Professional Pronouncements



**) The numbers 600-6999 are reserved for future development relating to other engagements based on ISSAI 100. Until the relevant pronouncements have been developed the three boxes representing these numbers may not appear on issai.org or other representations of the IFPP.*

2.4.4 Classification of INTOSAI Professional Pronouncements

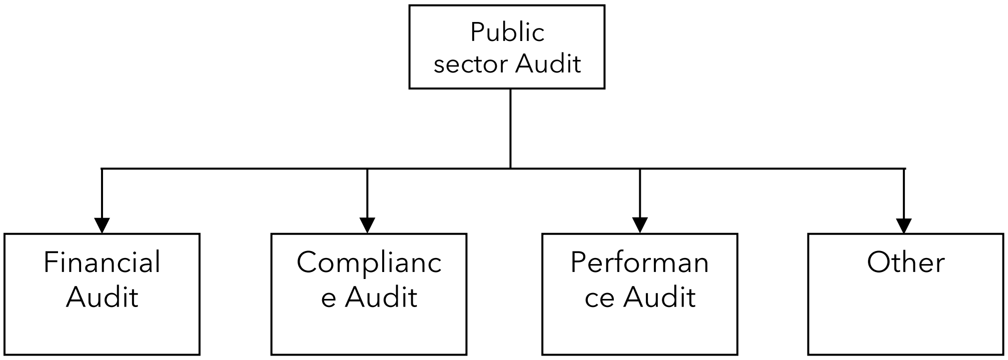
The Forum for INTOSAI Professional Pronouncements (FIPP) has decided to use the following criteria to classify and number INTOSAI pronouncements in connection with FIPP's decisions on approval of project proposals, exposure drafts and endorsement versions.

CATEGORY NUMBER	CATEGORY	CLASSIFICATION CRITERIA
INTOSAI P1-9	INTOSAI founding principles	Founding historical principles specifying the role and functions that SAIs should aspire to. These principles may be informative to Governments and Parliaments, as well as SAIs and the wider public and maybe used as reference in establishing national mandates for SAIs.
INTOSAI P10-99	INTOSAI core principles	Core principles that support the founding principles for an SAI, clarifying issues in relation to the SAI's role in society as well as high level aspirations for the proper functioning and professional conduct of an SAI.
ISSAI 100-129	Fundamental principles of public sector auditing	Defines basic set of concepts and principles that defines public sector auditing and the different types of engagements supported by the ISSAIs.
ISSAI 130-199	SAI organizational requirements (SAI level)	Requirements for organizational functions of an SAI that are designed to enhance the performance of quality audits.
ISSAI 200-299	Financial audit principles	These define the elements and principles of financial auditing, with reference to the fundamental principles of public sector auditing.
ISSAI 300-399	Performance audit principles	These define the elements and principles of performance auditing, with reference to the fundamental principles of public sector auditing.
ISSAI 400-499	Compliance audit principles	These define the elements and principles of compliance auditing, with reference to the fundamental principles of public sector auditing.
ISSAI 2000-2899	Financial audit standards	Standards for financial auditing, in conformity with the financial audit principles.
ISSAI 3000-3899	Performance audit standards	Standards for performance auditing, in conformity with the performance audit principles.

CATEGORY NUMBER	CATEGORY	CLASSIFICATION CRITERIA
ISSAI 4000-4899	Compliance audit standards	Standards for compliance auditing, in conformity with the compliance audit principles.
GUID 1900-1999	SAI organizational guidance	Guidance that supports the SAI in enhancing organisational performance in practice related to the organizational requirements and ISSAI implementation.
GUID 2900-2999	Supplementary financial audit guidance	Guidance that supports the auditor in the financial audit process on how to apply the ISSAIs in practice.
GUID 3900-3999	Supplementary performance audit guidance	Guidance that supports the auditor in the performance audit process on how to apply the ISSAIs in practice.
GUID 4900-4999	Supplementary compliance audit guidance	Guidance that supports the auditor in the compliance audit process on how to apply the ISSAIs in practice.
GUID 5000-5999	Subject matter specific guidance	Guidance that supports the auditor in understanding a specific subject matter and the application of the relevant ISSAIs.
GUID 9000-9999	Other guidance	Other guidance that supports the auditor.
Reserved for future development based on ISSAI 100		
ISSAI 600-699	Principles for other engagements	These define the elements and principles of other engagements, with reference to the fundamental principles of public sector auditing.
ISSAI 6000-6499	Standards for other engagements	Standards for other engagements in conformity with the fundamental principles of public sector auditing. This may include other INTOSAI audit types or standards developed by other recognized standard setters and adopted by INTOSAI.
GUID 6500-6999	Supplementary guidance on other engagements	Guidance that supports the auditor in other engagements on how to apply the ISSAIs in practice.
7000-8999		Available for any future needs

Summary

1) Types of Public Sector Auditing



Self-test questions

1. Internal Audit is carried out by?

a. The Institute of Internal Auditors

b. National Audit Department

c. Internal Audit Unit

d. National Audit Department of Internal Audit Unit

2. What are the nature and scope of audit work?

a. Reasonable precautions to safeguard collection and custody of public money.

b. Payments made with proper authority supported by sufficient vouchers

c. Due care has been taken into account for proper use, control, maintenance and disposal of all public stores.

d. All of the above

3. Which one is a NOT type of audits?

a. Financial Audit

b. External Audit

c. Compliance Audit

d. Performance Audit

4. External audit for public sector aims –

a. To achieve high level of public accountability

b. To have clear understanding about the organization's strategic directions and objectives

c. To maintain or improve the efficiency and effectiveness of internal control and governance.

d. All of the above

5. Which one is not the duty of public sector organizations?

a. Maintain proper accounting system and practice.

b. Perform record keeping.

c. Review statement and provide any related comments.

d. Prepare financial statements at the end of the day.

6. Which one of these are the powers of Audit General?

a. Have powers to call upon any person for explanation and information for all records, vouchers, documents and properties subject to audit.

b. Have powers to add or remove the details in the financial statements.

c. Have powers not to obtain the advice of law office upon legal matters.

d. None of the above.

7. Which one is Not a key challenge of public sector auditing?

a. Increase use of technology

b. Receive a demand for new types of audits.

c. Inadequate number and relative competence of Audit Personnel

d. Transitional method: Straight line and Reducing balance.

8. Which is the function of compliance audit?

a. To determine the true and fair view of the annual financial statement

b. To determine and examine evidence whether a financial or operating activity confirms to specified conditions, rules or regulations.

c. To assess or examine the extent to which an activity, programme or public institution operates efficiently and effectively.

d. All of the above .

9. Who will present the audit report to the PAC?

a. Public sector organizations

b. Auditor general department

c. Public accounts committee

d. None of the above

10. INTOSAI stands for –

a. The International Organization of Supreme Audit Institutions

b. International Organization of Audit

c. International Organization of Public Audit

d. International Organization of Public sector Audit

Answers to Interactive questions

Interactive Question 2.1

There are many indicators that could raise an auditor's suspicions but none of them are proof that fraud is taking place. The auditor would have to conduct suitable tests to find evidence that either confirms or negates their suspicions.

The signals could include:

- lack of records
- weak or non-existent internal controls
- poor or non-existent segregation of duties
- auditor has difficulty obtaining source documentation (because this could indicate such records have been destroyed or concealed)
- unsatisfactory explanations given to queries raised
- defensive attitude by staff, such as being unwilling to answer reasonable questions
- unusual payments in terms of amounts, frequency or nature, being made
- staff with lifestyles beyond the level commensurate with salary
- fragile accounting systems
- problems with the organization's bankers, solicitors and previous auditors
- staff who work long hours and never take a holiday because this might suggest they are worried others will discover discrepancies

Interactive Question 2.2

The auditor has verified 95 per cent of the BDT50 million income. This is good but there is no evidence of the remaining BDT2.5 million of income that is from other sources and there is potential for that to be materially mis-stated (that is, be wrong by BDT1 million or more). Some extra evidence should be sought to confirm the total income is BDT50 million.

Interactive Question 2.3

Performance Audit (PA) has been defined in various ways. Though there are variations in definition, it is common that PA will assess the performance of an entity whether tools may vary. National audit offices of countries across the world as well as the Supreme audit institution have defined the PA in various ways also. Whatever be, it is accepted that activities and results are the concern of performance auditing rather than reports or accounts. INTOSAI (2019) asserts that performance audits contribute to transparency and accountability. Therefore, SAI guidelines as well as practices of a country will define the measurement of PA. However, International Standards of Supreme Audit Institutions (ISSAI) 3000 to 3899 can provides a brief guidelines if the SAI follows INTOSAI.

Interactive Question 2.4

The advantage of principles over rules is the flexibility. All internal audit teams, whether in the public or in the private sector, can adopt processes and practices that comply with the principles whilst also fitting their context. Principles can also be written concisely because they do not have to be explicit about all the possible variations in circumstances. A rules-based approach would have the problem of either having simple rules, which do not fit every circumstance, or having very long and complicated rules, which cover (almost) every circumstance.

Principles-based codes usually operate on the basis of 'comply or explain'. Generally, an internal auditor is expected to comply with the principles but perhaps there are occasions where they choose not to comply because that would be in the best interests of stakeholders (not the internal auditor). In such situations the internal auditor could write down their reasons for non-compliance with the code.

The disadvantage of principles-based codes is that the subjective nature of principles may make it harder to judge when an internal auditor is in breach of them.

Interactive Question 2.5

As the Office of the Comptroller and Auditor General of Bangladesh (OCAG) is a member of INTOSAI and follows ISSAI, ISSAI 2000 – 2899 are applicable for the ministry of education for the financial audit.

Interactive Question 2.6

The purpose of the ISSAIs is to:

- Ensure the quality of the audits conducted.
- Strengthen the credibility of the audit reports for users
- Enhance transparency of the audit process
- Specify the auditor's responsibility in relation to the other parties involved.
- Define the different types of audit engagements and the related set of concepts that
- Provides a common language for public sector auditing.

Answers to Self Test

1	c	c. Internal Audit Unit National audit department do not perform the internal audit activity. It is duty of internal audit unit of an organization.
2	d	d. all of the above. Nature and scope of audit work include - reasonable precautions to safeguard collection and custody of public money, Payments made with proper authority supported by sufficient vouchers and due care has been taken into account for proper use, control, maintenance and disposal of all public stores.
3	b	b.External Audit. External and internal auditors can each be involved in different types of audit, e.g., regularity, performance and compliance audits.
4	a	a. to achieve high level of public accountability. External audit is conduct to ensure the accountability of public money. It is not conducted to check the organization strategy or efficiency.
5	c	c. Review statement and provide any related comments. Reviewing statement is the activity of an audit not an activity of accounting.
6	a	a. Have powers to call upon any person for explanation and information for all records, vouchers, documents and properties subject to audit. Audit general do not add or remove the details in the financial statement.
7	d	d. Transitional method: Straight line and Reducing balance. Public sector auditing is facing a number of challenges like use of technology, demand for new types of audits and lack of adequate skill personnel.
8	b	b. To determine and examine evidence whether a financial or operating activity confirms to specified conditions, rules or regulations. Financial audit determine the true and fair view of the annual financial statement. Performance audit assesses or examines the extent to which an activity, programme or public institution operates efficiently and effectively.
9	b	b.Audit or general department presents the audit report to the public accounts committee. Public sector organizations can not present to the public audit committee directly.
10		a.The International Organization of Supreme Audit Institutions (***INTOSAI***)

Additional Exercise

Additional Exercise 2.1

What are some of the distinguishing characteristics between government and private sector accountability?

Management is accountable for its action in both government and private sectors. Also, the Standards for the Professional Practice of Internal Auditing apply to internal auditors for both the government and private sectors, but the Government Auditing Standards only applies to federal auditors. Listed below are some of the distinguishing characteristics between government and private sector accountability.

1. Governmental sector's purpose is to carry out governmental functions by promoting the general welfare. Private sector's primary purpose is to benefit and financially enrich one or more specific individuals, through operating the entity in a manner to increase the value of their assets. This means that the primary beneficiaries of the governmental entity are the public while the primary beneficiaries of the private entity are its owner(s). Governmental sectors regulate the private sectors within its jurisdiction to make sure that certain standards are upheld for the well-being of the public.
2. The balance sheet and income statement are powerful tools of accountability for the private sector because they are operating for profit. The government's set goals and how they can be successfully reached are the government's powerful tools of accountability.
3. A private sector business will go out of business once it is not profitable. Once a government program outlives its usefulness, they are cancelled. Because of this, auditors serve several purposes in the accountability process, such as ensuring appropriate internal controls are successfully in place, reporting to the public on activities of government managers, reporting to other levels of government on use of funds, and reporting on the results of operations and financial position of the government.
4. Private sectors do not have any particular geographic constraints or commitments like governmental sectors do. A private entity can relocate their business to a different state or country while bringing the assets, jobs, and revenue with them to the new site.
5. Private sectors usually operate with objectives that can be clearly measured in a model of economic efficiency. The government sector cannot always do this because certain goals cannot always be measured based on establishing one program or factor. However, the government has an annual performance report review to see if the performance goals were or were not met and the reasoning. Each year these results areas compared to the goals and the results from the three previous years.
6. The private sector operates without the checks and balances of the government sector, but the SEC requires them to disclose financial and other information to the public to provide investors of knowledge for making judgment on the risk of investment.
7. Government entities are lawfully required to conduct their business through open, transparent processes to ensure accountability to the citizens.

Additional Exercise 2.2

What are the differences between the internal audit and external audit in public sector?

Answer: Do yourself from this chapter of workbook.

Technical References

1	International standards of supreme audit institutions (ISSAI)	INTOSAI

Glossary of terms

12-month expected credit losses:

The portion of lifetime expected credit losses which represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date.

Accounting estimate: A monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty.

Accrual accounting: The effects of transactions and other events and circumstances on a reporting entity's economic resources and claims are recognised in the periods in which they occur, even if the resulting cash receipts and payments occur in a different period. (*Conceptual Framework*: para 1.17)

Actuarial risk: This is the risk that the actuarial assumptions such as those on employee turnover, life expectancy or future salaries vary significantly from what actually happens.

Agricultural activity: Defined as the management of the biological transformation of biological assets for sale, into agricultural produce, or into additional biological assets.

Agricultural activities include, for example, raising livestock, forestry and cultivating orchards and plantations.

In its simplest form a biological transformation is the process of growing something such as a crop, although it also incorporates the production of agricultural produce such as wool and milk.

Agricultural produce: The harvested produce of an entity's biological assets.

Amortised cost: The amount at which the financial asset or liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance.

Antidilution: An increase in earnings per share or a reduction in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

Artificial intelligence (AI): Technology to help improve decisions made by machines, based on machine learning, in an attempt to make better decisions than humans can. AI requires pattern recognition and learning, rather than relying on a series of complex rules, so is not the same as expert systems, which failed to grasp the complexities of the real world and were unable to adapt to dynamic situations. AI systems use complex programming to know how to behave in certain situations, while machine learning promotes automatic learning without being prompted.

Assertions: The representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatement that may occur.

Asset: A present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits. (*Conceptual Framework, para. 4.2*)

Assurance engagement: An assurance engagement is one in which a practitioner aims to obtain sufficient appropriate evidence in order to express a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

Audit risk: The risk that auditors may give an inappropriate audit opinion when the financial statements are materially misstated. Audit risk has two key components: **risks of material**

misstatement in the financial statements and the risk of the auditor not detecting material misstatements in the financial statements (**detection risk**).

Audit sampling: Defined by ISA 530 *Audit Sampling* as:

"The application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population."

Auditor's expert: An individual or organisation possessing expertise in a field other than accounting and auditing, whose work in that field is used by the auditor in obtaining sufficient, appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (a partner or staff of the auditor's firm, or a network firm) or an auditor's external expert.

Big data: A term that describes those "datasets whose size is beyond the ability of typical database software to capture, store, manage and analyse."(McKinsey Global Institute, *Big data: The next frontier for innovation, competition and productivity*, 2011).

Biological asset: A living plant or animal.

Biological transformation: Comprises the processes of growth, degeneration, production and procreation that cause qualitative or quantitative changes in a biological asset.

Borrowing costs: Interest and other costs incurred by an entity in connection with the borrowing of funds.

Close family: A non-dependent parent, child or sibling.

Closing rate: The spot exchange rate at the reporting date.

Compilation engagement: An engagement in which a practitioner applies accounting and financial reporting expertise to help management with the preparation and presentation of financial information of an entity in accordance with an applicable financial reporting framework, and reports as required by the relevant ISRS.

Compliance risks: Risks arising from non-compliance with laws, regulations, policies, procedures and contracts.

Examples: breach of company law, non-compliance with accounting standards; listing rules; taxation; health and safety; environmental regulations; litigation risk against client.

Component: An entity or business activity for which the group or component management prepares financial information that should be included in the group financial statements.

Component auditor: An auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

Component materiality: The materiality for a component determined by the group engagement team.

Consolidated financial statements: The financial statements of a group presented as those of a single economic entity. (IFRS 10)

Control risk: The risk that a misstatement could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, **will not be prevented, or detected and corrected**, on a timely basis by the entity's system of internal control.

Corporate governance: Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined... providing shareholders, board members and executives as well as financial intermediaries and service providers with the right incentives to perform their roles within a framework of checks and balances (OECD, 2015).

An alternative definition is: The set of processes, customs, policies, laws and institutions affecting the way in which an entity is directed, administered or controlled. Corporate governance serves the needs of shareholders, and other stakeholders, by directing and controlling management activities towards good business practices, objectivity and integrity in order to satisfy the objectives of the entity.

Covered person: A person in a position to influence the conduct or outcome of the engagement.

Creative accounting: The active manipulation of accounting results for the purpose of creating an altered impression of the underlying financial position or performance of an enterprise by using accounting rules and guidance in a spirit other than that which was intended when the rules were written.

Credit loss: The difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive discounted at the original effective interest rate.

Credit transaction: A transaction where payment is deferred (eg, goods bought from company on credit terms).

Current cost: Current cost, like historical cost, is an entry value: it reflects prices in the market in which the entity would acquire assets or incur the liability.

Current value: The price paid for an asset or the liability value will be updated to reflect any changes since it was acquired or incurred. There are three main bases recognised by the *Conceptual Framework* that make up current value:

Data analytics: The process of collecting, organising and analysing large sets of data to discover patterns and other information which an organisation can use for its future business decisions.

Closely linked to the term data analytics is data mining.

Data mining: The process of sorting through data to identify patterns and relationships between different items. Data mining software, using statistical algorithms to discover correlations and patterns, is frequently used on large databases. In essence, it is the process of turning raw data into useful information.

Deductible temporary differences: Temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

Deferred tax assets: The amounts of income taxes recoverable in future periods in respect of:

- deductible temporary differences; and
- the carry forward of unused tax losses/unused tax credits.

Deferred tax liabilities: The amounts of income taxes payable in future periods in respect of taxable temporary differences.

Deficiency: A deficiency in internal control exists when:

- a control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or
- a control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

Defined benefit obligation: The defined benefit obligation is the present value of all expected future payments required to settle the obligation resulting from employee service in the current and prior periods.

Derecognition: The removal of all or part of a recognised asset or liability from an entity's statement of financial position. Derecognition normally occurs when that item no longer meets the definition of an asset or liability. (*Conceptual Framework*: para. 5.26)

Detection risk: The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level **will not detect a misstatement** that exists and that could be material, either individually or when aggregated with other misstatements.

Discontinued operation: A component of an entity that has either been disposed of, or is classified as held for sale, and:

- represents a separate major line of business or geographical area of operations;
- is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations; or
- is a subsidiary acquired exclusively with a view to resale.

Operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.

Disposal group: A group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction. (In practice a disposal group could be a subsidiary, a cash-generating unit or a single operation within an entity.)

(IFRS 5)

Dividend: An amount payable to shareholders from profits or other distributable reserves.

Economy: Attaining the appropriate quantity and quality of physical, human and financial resources (inputs) at lowest cost. An activity would not be economic if, for example, there was overstaffing or failure to purchase materials of requisite quality at the lowest available price.

Effective interest method: A method of calculating the amortised cost of a financial instrument and of allocating the interest income or interest expense over the relevant period.

Effective interest rate: The rate that exactly discounts estimated future cash payments or receipts through the expected life of the instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability.

Effectiveness: This is concerned with how well an activity is doing in achieving its policy objectives or other intended effects (outputs).

Efficiency: This is the relationship between goods or services produced and the resources used to produce them (process). An efficient operation or process produces the maximum output for any given set of resource inputs, or it has minimum inputs for any given quantity and quality of product or service provided.

Electronic commerce (e-commerce): Involves individuals and companies carrying out business transactions without paper documents, using computer and telecommunications links.

Electronic data interchange (EDI): A form of computer to computer data transfer. Information can be transferred in electronic form, avoiding the need for the information to be re-inputted somewhere else.

Electronic mail (email): A system of communicating with other connected computers or via the internet in written form.

Embedded derivative: A component of **a hybrid (combined) instrument** that also includes a **non-derivative host contract** – with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.

Emphasis of matter paragraph: A paragraph included in the auditor's report that refers to a matter **appropriately presented or disclosed** in the financial statements that, in the auditor's judgement, is of such importance that it is fundamental to users' understanding of the financial statements.

(ISA 706.7a)

Entity relevant to the engagement: An entity with respect to which the firm and covered persons are required to be independent. In the case of an audit engagement, the entity relevant to the engagement is the audited entity.

Equity instrument: Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Error: An unintentional misstatement in financial statements, including the omission of an amount or a disclosure.

Estimation uncertainty: Susceptibility to an inherent lack of precision in measurement.

Exchange difference: The difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

Exchange rate: The ratio of exchange for two currencies.

Expected credit losses (ECL): The weighted average of credit losses with the respective risks of the default occurring as the weights.

External confirmation: Audit evidence obtained as a direct written response to the auditor from a third party.

Fair: The financial statements reflect the commercial substance of the company's underlying transactions and the information is free from bias.

Fair value: Price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (IFRS 13, Appendix A)

Finance lease: A lease that transfers substantially all the risks and rewards incidental to ownership of an underlying asset.

Financial asset: Any asset that is:

- cash;
- an equity instrument of another entity;
- a contractual right:
  - to receive cash or another financial asset from another entity; or
  - to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
- a contract that will or may be settled in the entity's own equity instruments and which is:
  - a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
  - a derivative that will or may be settled other than by exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

Financial capital maintenance: Under a financial concept of capital maintenance, such as invested money and invested purchasing power, capital is synonymous with the net assets or equity of the entity.

Financial instrument: Any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

Financial liability: Any liability that is:

- a contractual obligation:
  - to deliver cash or another financial asset to another entity; or
  - to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
- a contract that will or may be settled in the entity's own equity instruments and which is:
  - a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

- a derivative that will or may be settled other than by exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

Financial risks: Risks arising from the company's financial activities (eg, investment risks) or the financial consequences of operations (eg, receivables risks).

Examples: going concern, market risk, overtrading, credit risk, interest rate risk, currency risk, cost of capital, treasury risks.

Firm commitment: A binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.

Forecast transaction: An uncommitted but anticipated future transaction.

Foreign currency: A currency other than the functional currency of the entity.

Foreign operations: Defined as any subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.

Forensic auditing: The process of gathering, analysing and reporting on data, in a predefined context, for the purpose of finding facts and/or evidence in the context of financial or legal disputes and/or irregularities and giving preventative advice in this area.

Forensic investigation: Undertaking a financial investigation in response to a particular event, where the findings of the investigation may be used as evidence in court or to otherwise help resolve disputes.

Forgivable loans: Loans which the lender undertakes to waive repayment of under certain prescribed conditions.

Forward contract: A commitment to undertake a future transaction at a set time and at a set price.

Fraud: An intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage.

Fraud risk factors: Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud. (ISA 240.12)

Functional currency: The currency of the primary economic environment in which the entity operates.

Future: This represents a **commitment** to an **additional transaction** in the future that limits the risk of existing commitments.

Gains: Increases in economic benefits. As such, they are no different in nature from revenue.

Going concern: Financial statements are normally prepared on the assumption that the reporting entity is a going concern, and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the necessity of liquidation nor the need to cease trading.

(*Conceptual Framework*: para. 3.9)

Goodwill: Any excess of the cost of the acquisition over the acquirer's interest in the fair value of the identifiable assets and liabilities acquired as at the date of the exchange transaction.

Governance: The term used to describe the role of persons with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. Those charged with governance may include management only when it performs such functions. (In the UK, those charged with governance include the directors (executive and non-executive) and members of the audit committee. In the UK, management will not normally include non-executive directors.)

Government assistance: Action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria.

Government grants: Assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

Grant date: The date at which the entity and other party agree to the share-based payment arrangement. At this date the entity agrees to pay cash, other assets or equity instruments to the other party, provided that specified **vesting conditions**, if any, are met. If the agreement is subject to shareholder approval, then the approval date becomes the grant date.

Grants related to assets: Government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

Grants related to income: Government grants other than those related to assets.

Greenhouse gas statement: A statement setting out constituent elements and quantifying an entity's greenhouse gas emissions for a period (sometimes known as an emissions inventory) and, where applicable, comparative information and explanatory notes including a summary of significant quantification and reporting policies.

Greenhouse gases (GHGs): Carbon dioxide (CO_2) and any other gases required by the applicable criteria to be included in the GHG statement, such as: methane; nitrous oxide; sulphur hexafluoride; hydrofluorocarbons; perfluorocarbons; and chlorofluorocarbons.

Gross investment in the lease: The sum of:

(a) the lease payments receivable by the lessor under a finance lease; and

(b) any unguaranteed residual value accruing to the lessor.

Group: A parent and all its subsidiaries.

Group audit: The audit of the group financial statements.

Group engagement partner: The partner or other person in the firm who is responsible for the group audit engagement and its performance and for the auditor's report on the group financial statements that is issued on behalf of the firm.

Group engagement team: Partners, including the group engagement partner, and staff who establish the overall group audit strategy, communicate with component auditors, perform work on the consolidation process, and evaluate the conclusions drawn from the audit evidence as the basis for forming an opinion on the group financial statements.

Hedge ratio: The relationship between the quantity of the hedging instrument and the quantity of the hedged item in terms of their relative weighting.

Hedged item: An asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that:

- exposes the entity to risk of changes in fair value or future cash flows; and
- is designated as being hedged.

Historical cost: The price paid for an asset or for the event which gave rise to the liability. The price will not change.

Independence: Freedom from conditions and relationships which, in the context of an engagement, would compromise the integrity or objectivity of the firm or covered persons.

Inherent risk: The **susceptibility** of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

Inquiry: Consists of seeking information of knowledgeable persons both financial and non-financial within the entity or outside the entity.

Inspection: Means the examination of records, documents or tangible assets.

Insurance contract: A contract between two parties, where one party, the insurer, agrees to compensate the other party, the policyholder, if it is adversely affected by an uncertain future event.

Insurance risk: A risk that is not a financial risk. The risk in an insurance contract is whether an event will occur (rather than arising from a change in something), for example a theft, damage against property, or product or professional liability.

Integrity: Being trustworthy, straightforward, honest, fair and candid; complying with the spirit as well as the letter of the applicable ethical principles, laws and regulations; behaving so as to maintain the public's trust in the auditing profession; and respecting confidentiality except where disclosure is in the public interest or is required to adhere to legal and professional responsibilities.

Interim financial report: A financial report containing either a complete set of financial statements (as described in IAS 1) or a set of condensed financial statements (as described in this standard) for an interim period.

Interim period: A financial reporting period shorter than a full financial year.

Internal audit function: A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes (ISA (UK) 610.14).

Internal control: A process designed, implemented and maintained by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. It follows that internal control is designed and implemented to address identified business risks that threaten the achievement of any of these objectives.

Investment circular: Any document issued by an entity pursuant to statutory or regulatory requirements relating to securities on which it is intended that a third party should make an investment decision, including a prospectus, listing particulars, a circular to shareholders or similar document.

Investment property: Property (land or a building – or part of a building – or both) held (by the owner or by the entity as a right-of-use asset) to earn rentals or for capital appreciation or both, rather than for:

- use in the production or supply of goods or services or for administrative purposes; or
- sale in the ordinary course of business.

Investment risk: This is the risk that, due to poor investment performance, there will be insufficient funds in the plan to meet the expected benefits.

Joint arrangement: An arrangement of which two or more parties have joint control.

Joint control: The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

Joint operation: A joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets and obligations for the liabilities relating to the arrangement.

Joint venture: A joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement. (IFRS 11, Appendix A)

Key audit matters (KAMs): Those matters, that in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. KAMs are selected from matters communicated with those charged with governance. In the UK, these include the most significant assessed risks of material misstatement (whether or not due to fraud) identified by the auditor, including those that had the greatest effect on:

- the overall audit strategy;
- the allocation of resources in the audit; and
- directing the efforts of the engagement team.

(ISA 701.8 & .A8-1)

ISA 701 identifies the purpose of including this information as being to:

- enhance the communicative value of the auditor's report;
- provide additional information to intended users; and
- assist users in understanding significant audit matters and the judgments involved.

(ISA 701.2)

Lease: A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time, in exchange for consideration.

Lease payments: Payments made by a lessee to a lessor in order to use an underlying asset during the lease term, less any lease incentives.

IFRS 16 requires lease payments to also include the exercise price of a purchase option if the lessee is reasonably certain to exercise that option, and any penalty payments for terminating the lease.

Lifetime expected credit losses: Those that result from all possible default events over the expected life of a financial instrument.

Loan: A sum of money lent for a time to be returned in money or money's worth.

Losses: Decreases in economic benefits. As such, they are no different in nature from other expenses.

Management commentary: A **narrative report** that provides a context within which to interpret the financial position, financial performance and cash flows of an entity. It also provides management with an opportunity to explain **its objectives and its strategies** for achieving those objectives. (IFRS Practice Statement)

Management's expert: An individual or organisation possessing expertise in a field other than accounting or auditing whose work in that field is used by the entity to assist the entity in preparing financial statements.

Material: Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report.' (IAS 1: para. 7)

Materiality: Information is material if omitting it, or misstating or obscuring it could influence decisions that users make on the basis of financial information about a specific reporting entity. (IAS 1, para 7)

Measurement: Elements recognised in the financial statements are quantified in monetary terms. This requires the selection of a measurement basis. (*Conceptual Framework*: para. 6.1)

This involves the selection of a particular basis of measurement. A number of these are used to different degrees and in varying combinations in financial statements. They include the following.

Measuring units current at the reporting date: This is a unit of local currency with a purchasing power as at the reporting date, in terms of a general prices index.

Misstatement of the other information: This exists when the other information is incorrectly stated or otherwise misleading (including because it omits or obscures information necessary for a proper understanding of a matter disclosed in the other information).

A misstatement of other information also exists when the statutory other information has not been prepared in accordance with the legal and regulatory requirements applicable.

(ISA 720.12 and Appendix 1)

Monetary items: Units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.

Natural capital: This is defined by the NCC in terms of forests, rivers, mountains, minerals, fish populations and even oceans.

Net investment in a foreign operation: The amount of the reporting entity's interest in the net assets of that operation.

Net investment in the lease: The gross investment in the lease discounted at the interest rate implicit in the lease.

Non-compliance: Refers to acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity, or on its behalf, by those charged with governance, management or employees. Non-compliance does **not** include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management or employees of the entity. (ISA (Revised) 250A.12)

Objectivity: Acting and making decisions and judgments impartially, fairly and on merit (having regard to all considerations relevant to the task in hand but no other), without discrimination, bias, or compromise because of commercial or personal self-interest, conflicts of interest or the undue influence of others, and having given due consideration to the best available evidence.

Obligation: A duty or responsibility that the entity has no practical ability to avoid.

A present obligation exists as a result of past events if the entity has already obtained economic benefits or taken an action, and as a consequence, the entity will or may have to transfer an economic resource that it would not otherwise have had to transfer.

Observation: Consists of looking at a procedure or process being performed by others.

Operating lease: A lease that does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

Operating risks: Risks arising from the operations of the business.

Examples: loss of orders; loss of key personnel; physical damage to assets; poor brand management; technological change; stock-outs; business processes unaligned to objectives.

Operating segment: This is a component of an entity:

- that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity);

- whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance; and
- for which discrete financial information is available.

The term 'chief operating decision maker' identifies a function, not necessarily a manager with a specific title. That function is to allocate resources and to assess the performance of the entity's operating segments.

Operational audits: Audits of the operational processes of the organisation. They are also known as management and efficiency audits. Their prime objective is the monitoring of management's performance, ensuring company policy is adhered to.

Option: This represents a commitment by a seller to undertake a future transaction, where the buyer has the option of not undertaking the transaction.

Options and warrants: Financial instruments that give the holder the right to purchase ordinary shares.

Other entity of public interest (OEPI): An entity which does not meet the definition of a Public Interest Entity, but nevertheless is of significant public interest to stakeholders (these are not straightforward to define but include insurance syndicates, pension schemes and smaller AIM listed entities)

Other information: Financial and non-financial information (**other than** financial statements and the auditor's report) included in an entity's annual report (such as summaries of key financial results, explanations of critical accounting estimates and financial measures or ratios).

Other long-term employee benefits: Employee benefits (other than post-retirement benefit plans and termination benefits) which do not fall due wholly within 12 months after the end of the period in which the employees render the service.

Other matter paragraph: A paragraph included in the auditor's report that refers to a matter **other than those presented or disclosed in the financial statements** that, in the auditor's judgement, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

(ISA 706.7b)

Person closely associated: This is:

(a) a spouse, or partner considered to be equivalent to a spouse in accordance with national law;

(b) a dependent child;

(c) a relative who has lived in the same household as the person with whom they are associated for at least one year;

(d) a firm whose managerial responsibilities are discharged by, or which is directly or indirectly controlled by, the firm/person with whom they are associated, or by any person mentioned in (a), (b) or (c) or in which the firm or any such person has a beneficial or other substantially equivalent economic interest; or

(e) a trust whose managerial responsibilities are discharged by, or which is directly or indirectly controlled by, or which is set up for the benefit of, or whose economic interests are substantially equivalent to, the firm/person with whom they are associated or any person mentioned in (a), (b) or (c).

Persons connected with a director: These include:

- directors' spouses, minor (including step) children

- a company with which a director is associated (ie, controls > 20% voting power)
- trustee of a trust whose beneficiaries include the director or connected person
- partner of the director or connected person

Pervasive effects: Pervasive effects on the financial statements are those that, in the auditor's judgement:

- are not confined to specific elements, accounts or items of the financial statements;
- if so confined, represent or could represent a substantial proportion of the financial statements; or
- in relation to disclosures, are fundamental to users' understanding of the financial statements.

(ISA (UK) 705.5)

Physical capital maintenance: Under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the entity based on, eg, units of output per day.

Plan assets: Those assets held by a long-term benefit fund and those insurance policies which are held by an entity, where the fund/entity is legally separate from the employer and assets/policies can only be used to fund employee benefits.

Post-employment benefits: Employee benefits (other than termination benefits) which are payable after the completion of employment. The benefit plans may have been set up under formal or informal arrangements.

Potential to produce economic benefit: An economic resource is a right that has the potential to produce economic benefits. *(Conceptual Framework,* para.4.14)

Presentation currency: The currency in which the financial statements are presented.

Professional scepticism: An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

Profits available for distribution: Accumulated realised profits (which have not been distributed or capitalised) less accumulated realised losses (which have not been previously written off in a reduction or reorganisation of capital).

Provision: A liability where there is uncertainty over its timing or the amount at which it will be settled.

Public interest entity:

- An issuer whose transferable securities are admitted to trading on a regulated market (
- A credit institution (in the UK, a bank or building society)
- An insurance undertaking

Qualifying asset: An asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Quasi-loan: The company agrees to pay a third party on behalf of the director, who later reimburses the company (eg, personal goods bought with company credit card).

Rate regulation: A framework for establishing the prices that can be charged to customers for goods and services and that framework is subject to oversight and/or approval by a rate regulator.

Rate regulator: An authorised body that is empowered by statute or regulation to establish the rate or range of rates that bind an entity.

Reasonable and informed third party: Consideration of whether the ethical outcomes required by the overarching principles and supporting ethical provisions have been met should be evaluated by reference to the perspective of an objective, reasonable and informed third party (sometimes referred to as the 'Third Party Test') (FRC Ethical Standard, Introduction section I14).

Recalculation: Consists of checking the arithmetical accuracy of source documents and accounting records.

Recognition: The process of capturing for inclusion in the statement of financial position or statement(s) of profit or loss and other comprehensive income an item that meets the definition of one of the elements of financial statements – an asset, a liability, equity, income or expenses. (*Conceptual Framework*: para. 5.1)

An asset or liability should be recognised if it will be both:

- Relevant; and
- Provide users of the financial statements with a faithful representation of the transactions of that entity

Regulatory deferral account balance: The balance of any expense (or income) account that would not be recognised as an asset or a liability in accordance with other Standards, but that qualifies for deferral because it is included, or is expected to be included, by the rate regulator in establishing the rate(s) that can be charged to customers.

Related party: A party that is either:

(a) a related party as defined in the applicable financial reporting framework; or

(b) where the applicable financial reporting framework establishes minimal or no related party requirements:

(1) a person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;

(2) another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or

(3) another entity that is under common control with the reporting entity through having:

  - common controlling ownership;
  - owners who are close family members; or
  - common key management.

However, entities that are under common control by a state (ie, a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

(ISA 550.10)

Related party transaction: A transfer of resources, services or obligations between related parties, regardless of whether a price is charged.

Reperformance: Means the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

Reporting entity: An entity that is required, or chooses, to prepare financial statements. A reporting entity can be a single entity or a portion of an entity or can comprise more than one entity. A reporting entity is not necessarily a legal entity (para. 3.10).

Retirement benefit plans: Arrangements whereby an entity provides benefits for its employees on or after termination of service (either in the form of an annual income or as a lump sum), when such benefits, or the employer's contributions towards them, can be determined or estimated in advance of retirement from the provisions of a document or from the entity's practices.

Return on plan assets: Defined as interest, dividends and other revenue derived from plan assets together with realised and unrealised gains or losses on the plan assets, less any costs of administering the plan and less any tax payable by the plan itself.

Right-of-use asset: An asset that represents a lessee's right to use an underlying asset for the lease term.

Risks of material misstatement: According to ISA 200, risks of material misstatement exist at two levels: the overall **financial statement level** (affecting many assertions) and the **assertion level** for classes of transactions, account balances and disclosures. Risks of material misstatement at the assertion level consist of **inherent risk** and **control risk**.

Scalability: Auditors should apply the requirements of an ISA to all entities regardless of their complexity, nature and circumstances.

Service organisation: A third-party organisation that provides services to user entities that are part of those entities' information systems relevant to financial reporting.

Short-term compensated absences: Compensated absences are periods of absence from work for which the employee receives some form of payment and which are expected to occur within 12 months of the end of the period in which the employee renders the services.

Short-term employee benefits: Employee benefits (other than termination benefits) that fall due within 12 months from the end of the period in which the employees provide their services.

Significant component: A component identified by the group engagement team: (a) that is of individual significance to the group, or (b) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements (ISA 600.9).

Significant deficiency in internal control: Those which in the auditor's professional judgement are of sufficient importance to merit the attention of those charged with governance.

Spot exchange rate: The exchange rate for immediate delivery.

Statutory other information: This includes the directors' report, the strategic report and the separate corporate governance statement, all of which is relevant here.

Structured entity: An entity that has been designed so that **voting or similar rights** are **not the dominant factor** in **deciding who controls** the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements.

(IFRS 12, Appendix A)

Sustainability: Meeting the needs of the present without compromising the ability of future generations to meet their own needs (UN, 2021).

Tax base: The amount attributed to an asset or liability for tax purposes.

Taxable temporary differences: Temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

Termination benefits: Employee benefits payable on the termination of employment, through voluntary redundancy or as a result of a decision made by the employer to terminate employment before the normal retirement date.

Those charged with governance: The person(s) or organisation(s) (for example, a corporate trustee) with responsibility **for overseeing the strategic direction** of the entity and obligations related to the **accountability** of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.

Those charged with governance include executive and non-executive directors and the members of the audit committee.

Transnational audit: An audit of financial statements which are or may be relied upon outside the audited entity's home jurisdiction for purposes of significant lending, investment or regulatory decisions; this will include audits of all financial statements of companies with listed equity or debt and other public interest entities which attract particular public attention because of their size, products or services provided.

True: The information in the financial statements is not false and conforms to reality.

Type 1 report: A report that comprises both of the following:

- A description, prepared by management of the service organisation, of the service organisation's system, control objectives and related controls that have been designed and implemented as at a specified date
- A report by the service auditor with the objective of conveying reasonable assurance that includes the service auditor's opinion on the description of the service organisation's system, control objectives and related controls and the suitability of the design of the controls to achieve the specified control objectives

Type 2 report: A report that comprises both of the following:

- A description, as in a Type 1 report of the system and controls, of their design and implementation as at a specified date or throughout a specified period and, in some cases, their operating effectiveness throughout a specified period
- A report by the service auditor with the objective of conveying reasonable assurance that includes:
  - the service auditor's opinion on the description of the service organisation's system, control objectives and related controls, the suitability of the design of the controls to achieve the specified control objectives, and the operating effectiveness of the controls; and
  - a description of the service auditor's tests of the controls and the results thereof.

Unavoidable costs: Unavoidable costs of meeting an obligation are the lower of:

- the cost of fulfilling the contract; and
- any penalties from failure to fulfil the contract

Underlying asset: An asset that is the subject of a lease, for which the right to use that asset has been provided by a lessor to a lessee.

Unearned finance income: The difference between:

(a) the gross investment in the lease; and

(b) the net investment in the lease.

Unguaranteed residual value: That portion of the residual value of the underlying asset, the realisation of which by the lessor is not assured or is guaranteed solely by a party related to the lessor.

User auditor: An auditor who audits and reports on the financial statements of a user entity.

Value in use: The present value of the cash flows, or other economic benefits, that an entity expects to derive from the use of an asset and its ultimate disposal (*Conceptual Framework*, para.6.17).

Vesting conditions: The conditions that must be satisfied for the other party to become entitled to receive the share-based payment.

Vesting date: The date on which all vesting conditions have been met and the employee/third party becomes entitled to the share-based payment.

Vesting period: The period during which the vesting conditions are to be satisfied.

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